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Wicked Problems: A Case for Shared Leadership in Higher Education

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Abstract

The environment in higher education has evolved to one of unprecedented disruption and higher education institutions must be responsive to remain relevant. Traditional strategic planning processes were not designed to cope with the complex issues, some of which are not just tough or persistent but are so difficult they can be classified as "wicked" and impossible for a single leader to address. Sharing leadership is an imperative but it is not easy. To be successful, the university must create new forms of infrastructure to support and sustain the new collaborative working relationships. This paper attempts to apply recent approaches to addressing problem complexity to key "wicked" problems in higher education and the use of shared leadership in the system design.

Key words: Shared leadership, shared governance, collaborative, interdisciplinary, STEM education

Wicked Problems Defined

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The environment in higher education has evolved to one of unprecedented disruption, rapid change, and nontraditional challenges (Terrence Franke, 2014). Traditional strategic-planning processes were not designed to cope with complex issues and many complex strategy issues are not just tough or persistent, they are "wicked." Wickedness does not refer to a degree of difficulty. In this context, wicked issues are ones where traditional processes are inadequate and, instead, require thinking that is capable of grasping the big picture, including the interrelationships among the full range of causal factors underlying them, and require broad, collaborative leadership and innovative approaches. Consistent with the work of Jon Kolko (2012) a wicked problem is a problem that is difficult or impossible to solve for as many as four reasons: incomplete or contradictory knowledge, the number of people and opinions involved, the large economic burden, and the interconnected nature of these problems with other problems.

Wicked Problem of Higher Education Institution Relevance

The role of higher education institutions has to be more responsive to the needs of its stakeholders, to remain relevant. For example, a 2013 Gallup survey conducted on behalf of the Lumina Foundation found that an overwhelming majority of business leaders say that even as demand for workers with degrees and other credentials rise, when it comes to making hiring decisions, a candidate's knowledge and skills far outweigh where that candidate went to college or their major. This is a major paradigm shift. Gallup further reports that, of their respondents, about

eight in 10 U.S. adults say that knowledge and applied skills are very important to managers making hiring decisions (Gallup, 2014).

The challenge to be responsive becomes even more complex when we factor in the rising cost of an education, the declining value of a college degree, low graduation rates, and differing success rates across social economic groups (Humphreys, 2012). The situation is further complicated by technology changes affecting how we communicate, how we learn, where we learn, what we want to know, and how we will use knowledge we have acquired (Shirky, 2008). Given the data and the magnitude, complexity and speed of change, higher education can no longer afford to continue to cater to a narrow profile of students and not prepare graduates for the multi-faceted world they will be facing (Mili, 2015).

In the opinion of the Lumina Foundation as stated in its 2014 report, higher learning is becoming ever more critical in the 21st century. To succeed in the workplace, students must prepare for jobs that are rapidly changing, use technologies and knowledge in areas that still are emerging and work with colleagues from (and often in) all parts of the world. The complex challenges that graduates must address as citizens are increasingly global. The transformation of higher education to produce these graduates is a wicked problem worth solving.

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Wicked Problem in Providing STEM Education

According to the US Department of Education, the United States has developed as a global leader, in large part, through the genius and hard work of its scientists, engineers, and innovators. In a world that is becoming increasingly complex, it is more important than ever for our youth to be equipped with the knowledge and skills to solve tough problems, gather and evaluate evidence, and make sense of information. These are the types of skills that students learn by studying science, technology, engineering, and math—subjects collectively known as STEM. Yet today, few American students pursue expertise in STEM fields—and we have an inadequate pipeline of teachers skilled in those subjects (USDE, 2015).

Data from the U.S. Bureau of Labor Statistics (BLS) shows that the jobs of the future are STEM jobs (BLS, 2014). The demand for professionals in STEM fields is projected to outpace the supply of trained workers and professionals. Additionally, STEM competencies are increasingly required for workers both within and outside specific STEM occupations. A recent report by the President's Council of Advisors on Science and Technology (PCAST) estimates there will be one million fewer STEM graduates over the next decade than U.S. industries will need (PCAST, 2012).

The need is understood, however, the problem of developing skills in STEM is so complex that the Federal Committee on STEM Education (CoSTEM) required the participation of 13 agencies and the May 2013, 5-year Federal Strategic Plan for

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STEM Education, involves the input and collaboration of over 21 agencies. The purpose of the CoSTEM is to coordinate Federal programs and activities in support of STEM education. Despite the federal government's efforts, as outlined by Fatma Mili, the Associate Dean of Educational Research and Development, Purdue University (Fatma, 2015) there is a growing misalignment between STEM education and contemporary needs, even with initiatives to reform, innovate and adapt. The problem seems deep seated, persistent and immune to efforts to resolve. Apparently, the robustness and resilience of the current educational system has enabled it to thwart attempts at comprehensive reform.

Governance of Wicked Problems

Not all problems are wicked. Head and Alford (2015), in their research, have identified a spectrum of problem types. On one end there are tame problems which are those that can be resolved using standard or routine solutions. They have low levels of complexity and low perceived levels of uncertainty. In general, the more complex and diverse the situation, the more wicked the problem becomes. The more wicked the problem the more important are nonstandard processes such as adaptive and collaborative management with skills in dealing with complexity, uncertainty and disagreement.

As the leadership challenges grow more complex and it becomes increasingly more difficult, if not impossible, for a single leader to be effective, sharing leadership becomes an imperative. Shared or collaborative leadership helps in at least three

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ways. First, collaboration increases the likelihood that the nature of the problem can be better understood with the input of diverse insights. Second, collaboration increases the likelihood of finding better solutions and agreement from the process of pooling knowledge and joint problem solving. Third, collaboration facilitates the implementation of solutions as the process involves shared contributions and coordinated actions in putting an agreed solution into practice (Head and Alford, 2015).

Achieving efficient collaboration and coordination is no easy feat. Getting partners to the table requires the right environment. As claimed by Crosby and Bryson (2010) there must first be some catalyst underpinning the collaboration. For higher education, the increasingly challenging operating environment may become the catalyst and the motivation for change in leadership practices. These leaders then become the sponsors and champions to facilitate collaborative team building. However, to be effective the team will require the right environment. There must be: (1) regular communication to reveal information, facilitate mutual adjustments, and establish common ground; (2) trust and mutual commitment to increase the probability of participants disclosing relevant information; and (3) autonomy to make and follow through on commitments.

Going Forward

Addressing wicked problems involves two distinct sets of skills: (1) the ability to identify wicked problems because not all problems are wicked; and (2) the ability

to create and maintain interdisciplinary/inter-sector collaborations – shared leadership – to effectively address wicked problems. To be successful, the university must create new forms of infrastructure to support and sustain the new collaborative working relationships. Leadership roles will need to include inducing others to adapt to changing circumstances as leaders themselves embrace adaptive leadership. That right environment will be that balance between challenging the team to tackle wicked problems and keeping the resulting stresses within a productive range.

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Linguistic Perception of Corporate Responsibility Disclosure: The Case of Japanese Idemitsu

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Corporate responsibility reports contain important contents for the stakeholders and how they are perceived is of paramount significance. Most of the studies on corporate responsibility disclosure analysis have focused on a binary response to the level of disclosure of a certain economic, social, environmental or governance issue, however, how a disclosed item is being perceived by the user has not been taken into consideration. In this study, a content analysis framework based on fuzzy linguistic variables is proposed to measure the level of sustainable and responsible practices perceived by the stakeholders. A case is examined to illustrate the linguistic perception of corporate responsibility disclosures. The results demonstrated a significant difference between Perception of Disclosure, using linguistic variables and most common sustainability indicators, and a Boolean analysis based on sustainability reporting indicators. The approach helps

companies in developing a more robust stakeholder management program and to better respond to stakeholders' demands.

1. Introduction

Stakeholders receive significant information with regard to the companies' activities through their sustainability reports. Nonetheless, the perception of the users of these reports is not necessarily based on how much information is disclosed but how comprehensive these information are in covering every economic, social, governance, ethical, and environmental issues in relation to companies' activities. The objective of this study is to measure "perception of disclosure" using linguistic variables. Perception of disclosure (POD) simply means "the extent to which the disclosures in the report are perceived as comprehensive to the users". To test POD based on linguistic variables, using both crisp and fuzzy sets, and in order to compare it with a Boolean analysis, a case study from the Japanese energy sector is examined. The outline of the paper is as follows. First, the theoretical background is expatiated upon, then method and the case are introduced. Next, the results and discussions are presented and finally the conclusion and limitations of the paper are explained.

2. Theoretical Background

2.1 The Concept of Sustainability

Starting in the 1960s, diverse stakeholders, including governments, media and the broader public are increasingly concerned with organizations' commitment to

general governance standards, environmental and social issues as well as community involvement. The UN convened the World Commission on Environment and Development in 1983 (Brundtland Commission) to address widespread concern about growing socioeconomic inequalities, the depletion of natural resources, and environmental destruction. The Commission had the view that the answer to the aforementioned global challenges was sustainable development (United Nations 1987, p. 37).

Primarily been understood as environmental sustainability (Crane and Matten, 2007) the concept was developed further and now embraces environmental, social, and economic sustainability. This is also inherent in the notion of the triple bottom line, which entails the thinking that people, planet and profit are inextricably linked with each other. Organizations can create long-term value by striving to expand the life span of societies, ecosystems, and economies (Elkington, 2010). Although the concepts of sustainability and *corporate social responsibility* (CSR) have gained a remarkable position in the management literature (De Bakker et al. 2005), there is still uncertainty about how to adequately define them (Dahlsrud, 2008). In practice and in the pertinent literature the distinction between sustainability and CSR is largely neglected (Hahn and Kühnen, 2013).

2.2 Sustainability Reporting and Global Reporting Initiative

Firms are increasingly held accountable for the impact of their activities on society (Hahn and Kühnen, 2013). To reduce information asymmetries between companies

and their stakeholders, firms are expected to communicate their behavior and to comply with the norm of corporate transparency (Braendle and Noll, 2006). According to Ziek (2009, p. 137), sustainability communication is an "often-overlooked component of sustainability research", because it remains ambiguous and vague as the entire sustainability concept (Dahlsrud, 2008). Therefore, each organization's communication approach varies and depends on the firm's institutional background (Baughn and McIntosh, 2007), business unit in charge (Hockerts and Moir, 2004) as well as size (Spence et al., 2003). Furthermore, the sustainability communication means also distinguish from the annual report being employed (Cerin 2002) to non-financial reporting (Chatterji and Levine, 2006) to corporate websites (Wanderley et al. 2008). By adequately using diverse communication channels, organizations are able to mitigate risks associated with sustainability issues and obtain legitimation from their stakeholders (Ziek 2009). Although there is only very limited regulatory guidance on sustainability reporting in most countries (Manetti and Becatti 2009), projects such as the *Global Reporting Initiative* (GRI), a multi-stakeholder forum dedicated to providing guidance on sustainability reporting, try to overcome this gap (GRI 2013).

The GRI emphasizes that a company considers those environmental and social aspects that are significant to its key stakeholders and have impact on its business. Reports should focus on matters that can be considered as key in achieving the organization's goals in alignment to its impact on society. The latest version of GRI, G4, is structured in a way that it could serve both, small and large

organizations, and also shows how reporting can be presented stand-alone or in annual reports. The GRI guidelines are regarded as the de facto global standard for voluntary sustainability disclosure (KPMG, 2011).

3. Methods

3.1 Most Common Indicators (MCIs)

Binary analysis of general and specific standard disclosures only demonstrates to what extent a company has complied with disclosure standards such as GRI and *Integrated Reporting (*IR), however, it cannot show how such disclosures are perceived by the users. Moreover, the number of disclosures are not necessarily emblematic of better communication and disclosure practices. The perception captured using linguistic variables may present a better approach for comprehending the implications of disclosures for the users, i.e. stakeholders, and how they perceive them.

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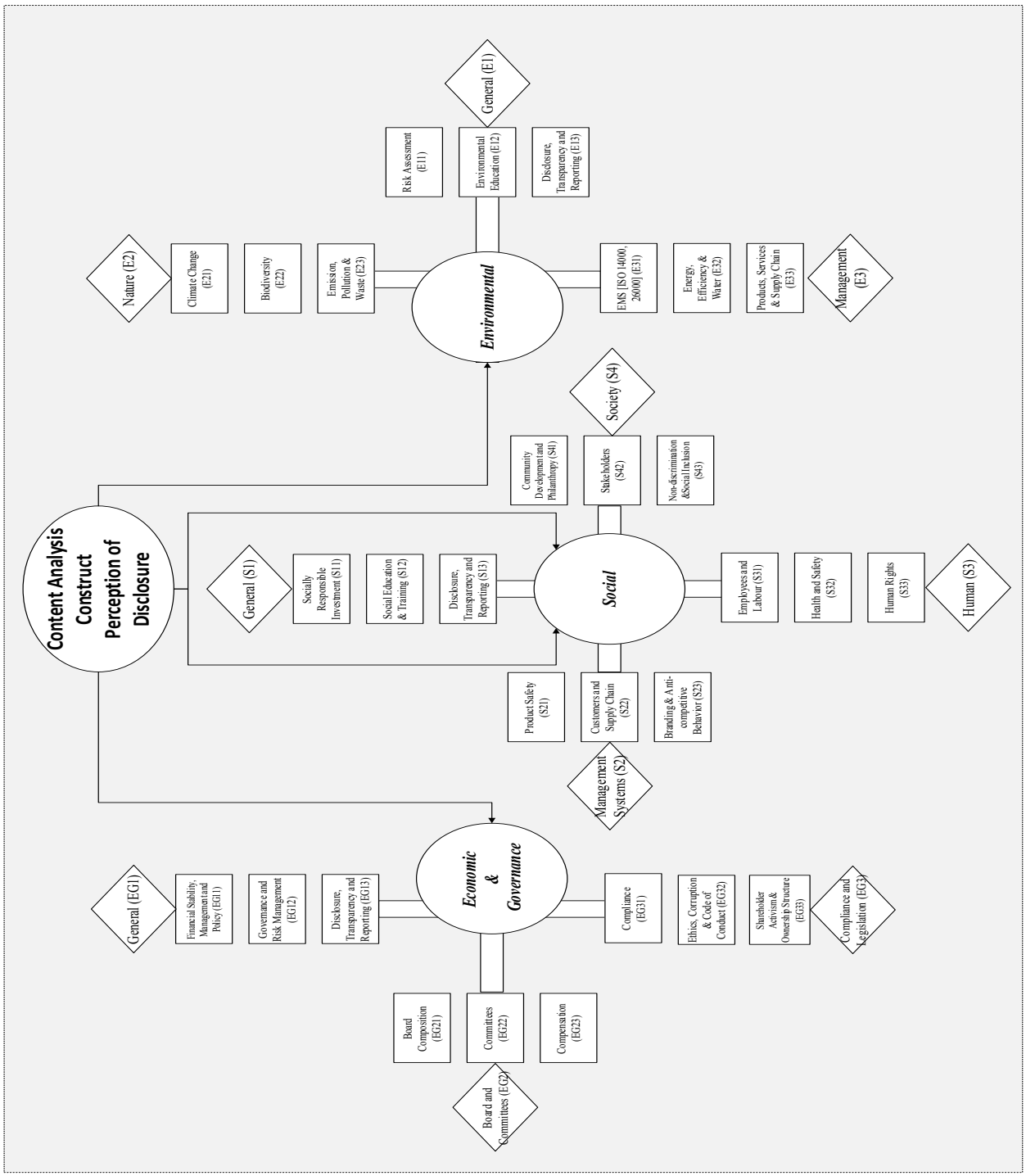

Figure 1 – MCIs of Corporate Sustainability – Adapted from Rahdari & Anvary Rostamy (2015)

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A perception based on linguistic implications may differ in results, however, to ensure that the results are not affected by using the same set of indicators that are used to produce the sustainability report, a general set of sustainability indicators, developed by Rahdari and Anvary Rostamy (2015), are used. The Most Common Indicators (MCIs) are a general set of corporate sustainability indicators that synthesize the most commonly used indicators from a large set of prevalent *Corporate Social Responsibility* and sustainability ratings systems, guidelines, frameworks, and management systems. Figure 1 demonstrates the corporate sustainability MCIs developed as a general set of sustainability indicators.

3.2 Fuzzy Logic

The traditional models of problem solving only deals with crisp decision problems and fail to account for the uncertainty that exists in the real world. Most of the problems in the real world are fuzzy problems (Bellman & Zadeh, 1970; Zadeh, 1965). In order to solve these types of problem, Professor Zadeh (1965) introduced the fuzzy concepts and fuzzy sets. Fuzzy sets and numbers can be defined in the following manner. Let X be a universe of discourse, $\tilde{A}$ is a fuzzy subset of X such that for all $x \epsilon X$. there is a number $\mu_{\tilde{A}}(x) \epsilon [0, 1]$ which is assigned to present the membership of x to $\tilde{A}$, and $\mu_{\tilde{A}}(x)$ is called the membership function of $\tilde{A}$. For instance, in a discrete fuzzy sets with finite, countable elements the set $\tilde{A}$ can be displayed as follows:

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$\tilde{A} = \{(1, 0.2) , (2, 0.4) , (6, 1) , (7, 0.9) , (9, 0.5)\}$

(1)

And in the case of a continuous fuzzy set, the set can be simply defined by determining the membership function $\mu_{\tilde{A}}(x)$ for the Universal set considered (X). By way of illustration take the real numbers (R) near 0 as a set. The membership function can be defined as follows:

$\mu \tilde{A} (x) = 1/(1+x2)$

(2)

So the membership degree of numbers 0, 1, -2 would be as follows:

$\mu \tilde{A} (0) = 1; \mu \tilde{A} (1) = 0.5; \mu \tilde{A} (-2) = 0.2$

(3)

And the set will look like this:

$\tilde{A} = \{(-2, 0.2) , (0, 1) , (1, 0.5)\}$

(4)

A triangular fuzzy number $\tilde{A}$ can be defined by a triplet (a, b, c). The arithmetic operations of fuzzy sets utilized in this study followed that of Güngör, et al., (2009).

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Table 1 – Linguistic Scale (Values) and Fuzzy Numbers

Linguistic Scale	Definition of the Linguistic Variables	Crisp Numbers	Linguistic Values
Very Low (VL)	No Disclosure.	1	(0,0,0.2)
Low (L)	Implicitly mentioned and not identified as an issue.	2	(0,0.2,0.4)
Medium (M)	Identified as a peripheral issue.	3	(0.2,0.4,0.6)
High (H)	Identified as a sub-topic or material issue (but not as a main topic).	4	(0.4,0.6,0.8)
Very High (VH)	Identified as a material issue/main topic.	5	(0.6,0.8,1)
Excellent (E)	Full transparency.	6	(0.8,1,1)

The table above (Table 1) demonstrates the linguistic scale, Definition of the Linguistic Variables, Linguistic Values, and the corresponding Crisp Numbers that will be used for the analysis.

3.3 Content Analysis: Crisp and Fuzzy

Content analysis consists of data collection, coding, analyzing, and interpreting (Weber, 1990; Tangpong, 2011) and frequency counting is a standard procedure for measuring the construct of interest (Duriau, Reger, & Pfarrer, 2007). This study utilizes a predefined framework for coding (MCIs) and does not use an open ended procedure (Strauss & Corbin, 1990). The given linguistic scores is the average POD of all entries; using linguistic variables (VL to VH). For the unit of analysis two measures of the number of sentences and the number of entries were devised.

The number of sentences is defined as the sum of all sentences referring to the aspect/subject from all entries, playing the role of the main unit of analysis. The number of entries is defined as a section/part of the report referring to the aspect/subject (e.g. if two sections are referring to Socially Responsible Investment the # of entries would equal 2), playing the role of the secondary unit of analysis.

This study attempts to answer two fundamental questions. Firstly, does POD transcend Boolean analysis in capturing the perception of a sustainability report user? And secondly, is there any difference between crisp and fuzzy linguistic perception of disclosure? POD's linguistic variables are transformed into fuzzy numbers so as to measure them quantitatively. They also are transformed into crisp numbers for the sake of comparison. Then, they are compared with scores that are yielded from disclosures based on GRI indicators.

4. Case Study: Idemitsu

To illustrate POD using fuzzy linguistic variables as a method for measuring the effectiveness of disclosure in sustainability or CSR reports, the case study of a Japanese company is presented. The Idemitsu Group was founded by Sazo Idemitsu (1885–1981) in 1911 in Japan. Idemitsu operates on a global level through three business segments: *core businesses*, including fuel oil, basic chemicals and renewable energy; *resource businesses*, including oil exploration, coal, uranium and geothermal power; and *functional materials businesses*,

including lubricants, performance chemicals, electronic materials and agricultural biotechnology.

It has published sustainability or CSR reports since 2001. The report selected for this study is the Idemitsu Group 2014 report “Realizing a Sustainable Society” which is published both in print and online version in 2015. It provides a comprehensive range of information covering nonfinancial topics in addition to a business summary, management plans and summarized financial data in order to help readers gain a broad understanding of the Group’s activities. The report contains Standard Disclosures of GRI G4. A Limited Independent Assurance of the report was carried out by Deloitte Tohmatsu.

5. Results and Discussions

Idemitsu asserts to practice the concept of "respect for human beings" in the conduct of business using five basic principles which were put forth by the founder viz. “Respect for Human Beings”, “Great Family-like System”, “Independence and Self-Governing”, “Do Not Be a Slave of Money”, and “From Producers to Consumers”. It has sought to meet the high expectations of society and to earn its trust (Idemitsu Group, 2015, pp. 4-5). The company sets four strategic goals for its corporate responsibility (promoting consumer benefits, industrial competitiveness, energy security of Japan, and contributing to the development of economies in emerging and developing nations) (Idemitsu Group, 2015, p. 6). Considering its field of operation, Idemitsu identifies “safety assurance and environmental

protection" as the most important issues to the company in non-financial fields. Then, it recognizes maintaining positive relations with stakeholders, improving transparency, and promoting sustainable growth by fulfilling social responsibility as the duty of a good corporate citizen. The company implements several CSR best practices such as flexible working hours for employees.

Idemitsu identified "Common Group wide Risk Response", "Compliance", "Safety and Security", "Quality Assurance and Product Safety", "Employment and Support for Employee Growth", "Health Management", "Global Warming Prevention ", "Resource Conservation", "Promoting Green Procurement", "Expanding Eco-Friendly Products and Services", "Minimizing Environmental Contamination Risks", and "Reinforcing Environmental Management Infrastructure" as its core CSR issues.

In terms of general disclosures, Idemitsu only discloses 0.50 (29 out of 58) of GRI's General Standard Disclosures (as defined by GRI G4). The company disclosed only 14 of 91 GRI performance indicators, merely complying with the Core "in accordance" option of GRI G4 guideline. Of these indicators 7 (20.59%), 6 (15.45%), and 1 (11.11%) were respectively environmental, social, and economic. Idemitsu's disclosed economic & governance, social (including labour, human rights, society, and product responsibility), and environmental performance indicators (as a percentage of the respective indicator category) are presented

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below. For instance, an approximate 7% on labour indicators shows that only 1 of 16 labour performance indicators were disclosed by the company.

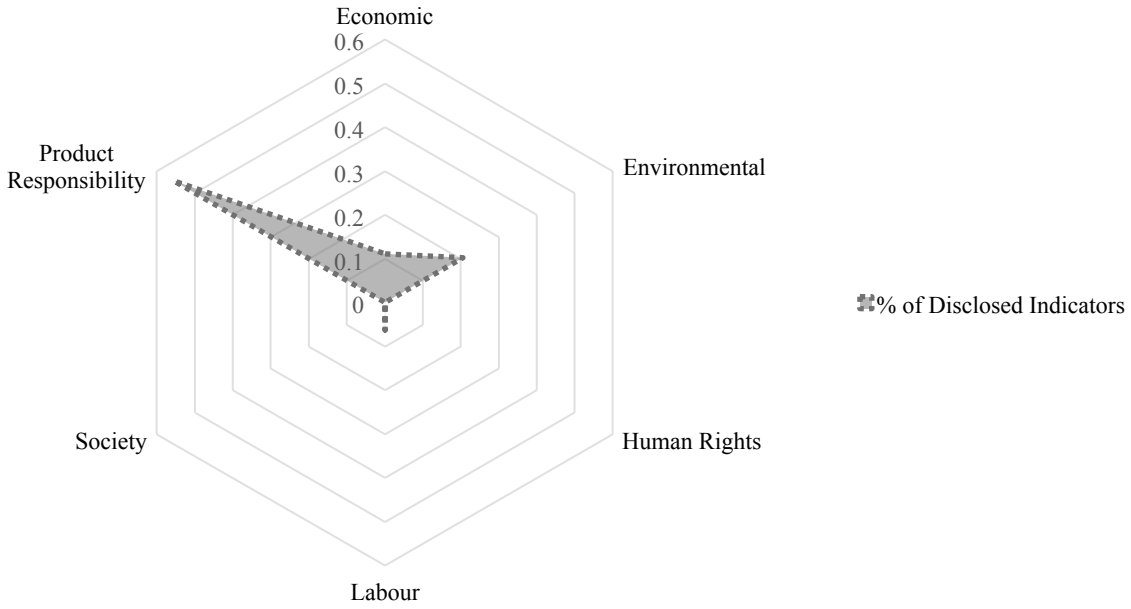

Figure 2 – The level of Disclosed Performance Indicators based in GRI G4

Idemitsu's overall disclosure on economic & governance, social, and environmental indicators based on GRI performance indicators and MCIs is summarized in Figure 3. The Boolean analysis demonstrates a significant difference between disclosures based on GRI and corporate sustainability indicators (i.e. MCIs) used in the study.

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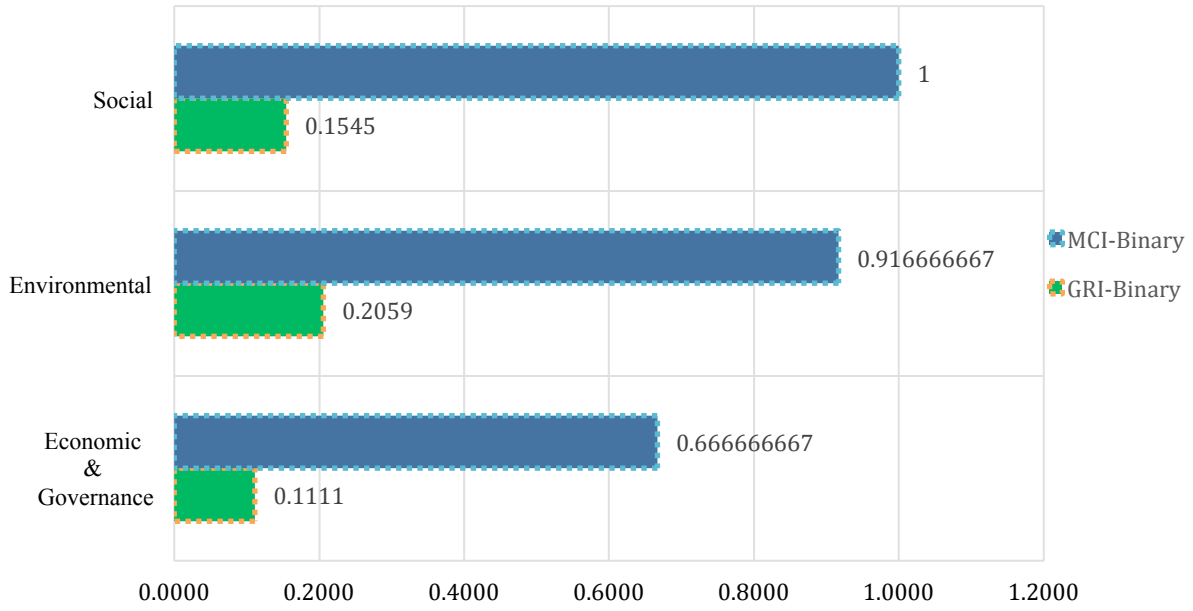

Figure 3 - Disclosed Items (based on GRI indicators and MCIs)

Idemitsu's disclosed items based on the GRI indicators average at around 15.38% while this figure for perception based on crisp and fuzzy linguistic average at around 39.23% and 45.26% respectively. The following figure (Figure 4) compares the GRI's binary (0 and 1) disclosure (using GRI performance indicators) with the POD based on MCIs using crisp and fuzzy linguistic variables.

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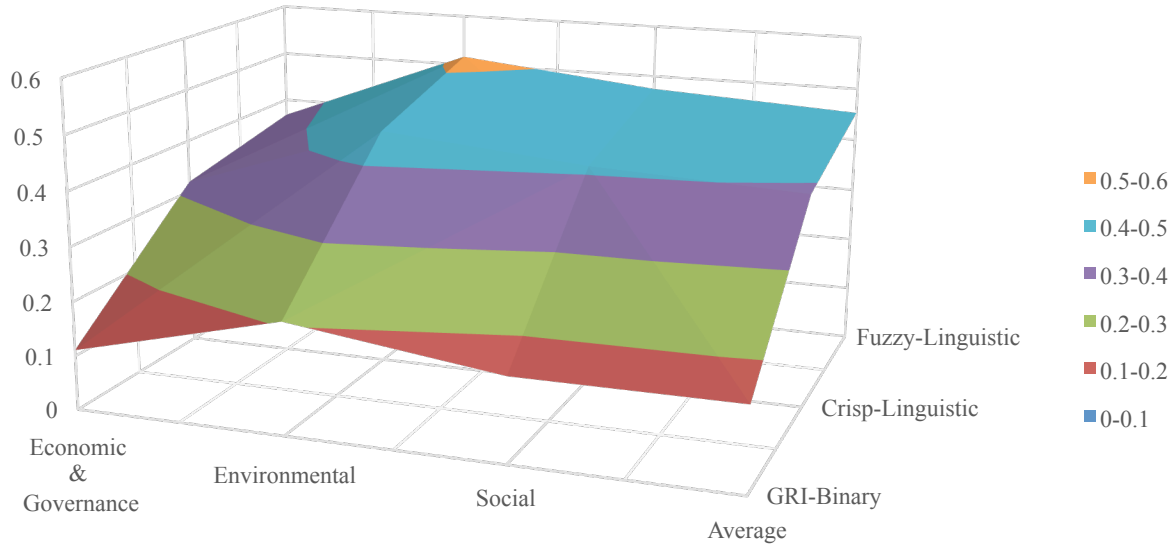

Figure 4 - Disclosed Items (GRI) vs. POD (using Crisp and Fuzzy numbers)

As it is evident from the graph, GRI Boolean analysis shows a low disclosure level in comparison with the analyses conducted using POD (both crisp and fuzzy). This may results from the fact that Idemitsu's CSR report does not fully comply with either of the GRI's "in-accordance" options.

To extend the analysis, sub-groups and criteria, can be separately analyzed. Ten sub-groups exists within MCIs framework including General (Governance and Economics), Board and Committees, Compliance and Legislation; General (Social), Management System, Human, and Society; General (E), Nature, and Management. 30 criteria have also been identified as "main" indicators (and not

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measures) of corporate sustainability that are all categorized under the ten sub-groups. A content analysis based on MCIs at sub-group level using the number of sentences and the number of entries (as two units of analyses) showed that General (Economic and Governance) criteria, Human criteria, and Nature criteria were the top sub-groups in each category, based on the number of sentences.

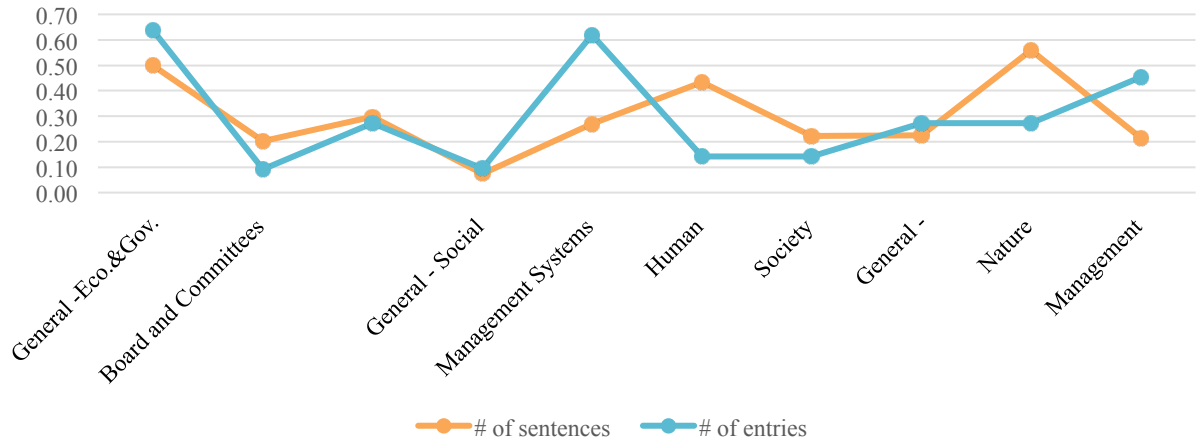

Figure X – Content Analysis at Sub-group Level - Based on MCIs

But the question remains, is there any difference between linguistic POD using crisp and fuzzy numbers? Yes, in short. However, in this study, they showed the same direction and almost procured the same results. When comparing the POD based on fuzzy and crisp normalized scores, no significant difference was found between the scores, only that fuzzy POD provides a more conservative measure than the score based on crisp numbers and it is intrinsically linked to linguistic variables.

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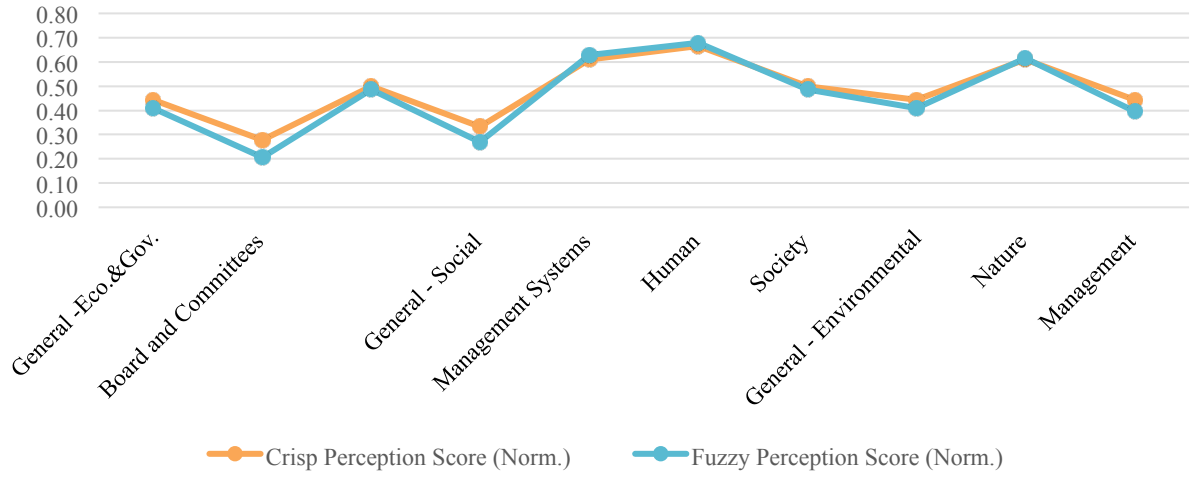

Figure X - POD at Sub-group Level - Based on MCIs

For the unit of analysis two measures of the number of sentences and the number of entries were selected. A content analysis based on MCIs at criteria level using these two measures showed that Governance and Risk Management, Compliance, and Committees were the most controversial issues among Economic and Governance criteria. Economic and Governance criteria cover 29% of the volume of all related texts covering performance indicators.

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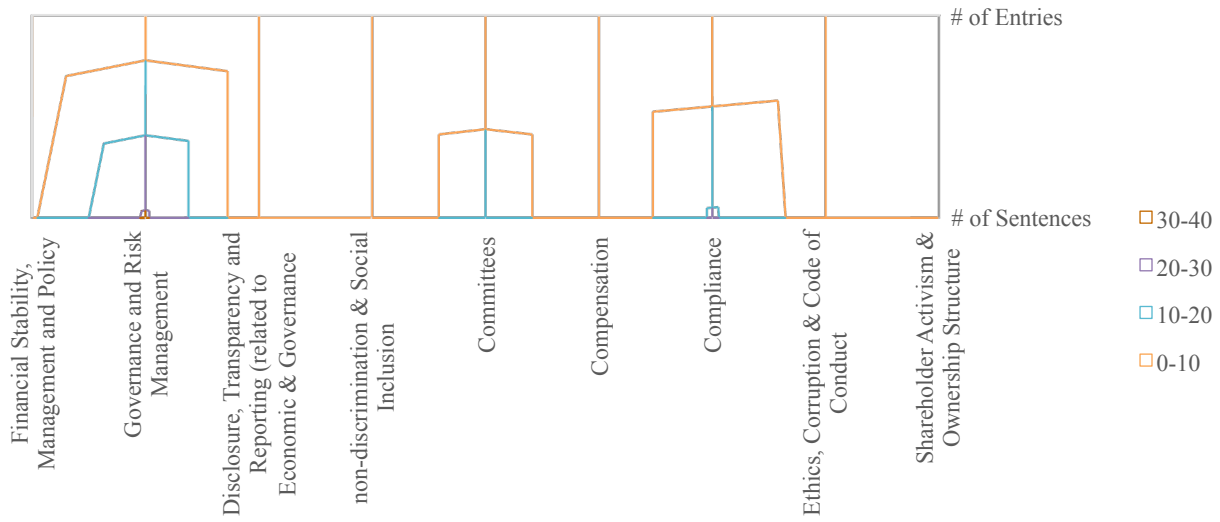

Figure X - Perception of Governance and Economic Disclosure at Criteria Level - Based on MCIs

42% of the text covering performance indicators was allocated to the social category. Employees and Labour, Customers and Supply Chain, and Community Development and Philanthropy were the top MCIs in social category, based on the number of sentences.

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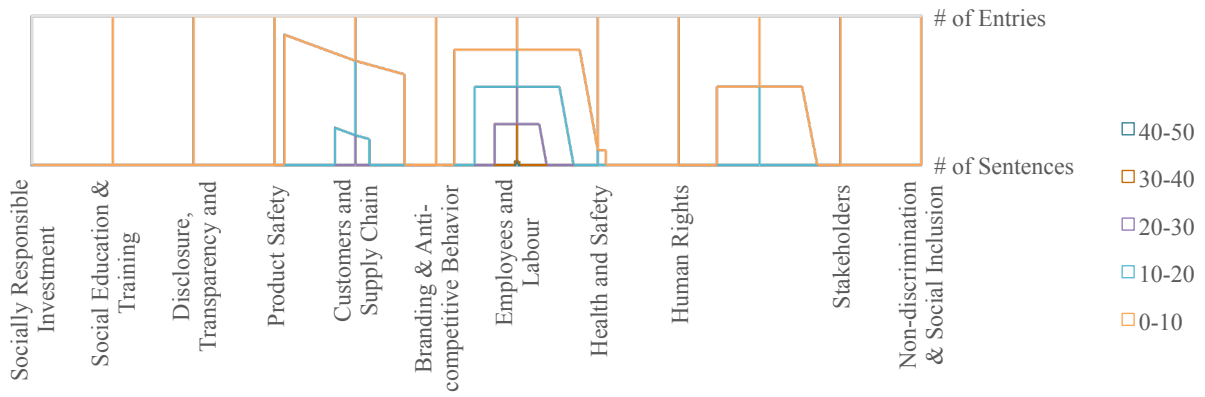

Figure X - Perception of Social Disclosure at Criteria Level - Based on MCIs Emission, Pollution & Waste, Disclosure, Transparency and Reporting (related to Environment issues), and Energy, Efficiency & Water were the top three environmental performance indicators. Environmental performance indicators covered 29% of performance indicators.

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Figure X - Perception of Environmental Disclosure at Criteria Level - Based on MCIs

The normalized fuzzy and crisp POD scores at the criteria level are presented in the appendixes A, B, and C. The results showed a relatively small difference between fuzzy and crisp POD in comparison with the results derived from the Boolean analysis e.g. GRI index ticks. On balance, the results demonstrates that POD can unravel many aspect of a sustainability report, primarily the content that is conveyed to the users, that are left unturned or underappreciated by the GRI index approach taken for the purpose of standardization. The content of Idemitsu's examined sustainability report goes beyond mere compliance with the sustainability reporting standard and is more useful than the index ticking suggests.

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In the case of Idemitsu, POD revealed that governance and risk management, employees and environmental issues are at the centre of the company's response to the stakeholders' concerns and demands. This is partly congruent with the company's assertions that "respect for human beings" and "safety assurance and environmental protection" are the crux of its responsibility towards the society. However, this is not traceable in a box ticking approach. In summary, despite "in accordance" options and Indexing's numerous benefits such as comparability and trend analysis, the substance of a report is conveyed to the stakeholders through both words and numbers that they perceive.

This perception is subjective to a considerable extent, however, it forms the basis for most of the decisions made by the stakeholders that would influence the company, its employees, suppliers, customers, and the society at large. Therefore, companies should take heed of the material content, indicators and subjects and not just disclosing more indicators. The approach also assists companies in developing a more robust stakeholder management program and materiality analysis through enhanced communications and understanding the strengths and weaknesses of such a system. Organizations can better comprehend and serve stakeholders demands when they know what information they have provided for them.

6. Conclusion, Limitations, and Future Research

The study investigated the POD in a sustainability report from a Japanese business group using linguistic variables and fuzzy numbers and, then, compared and

contrasted the results with that of a binary analysis based on GRI's performance indicators. The results showed a significant difference between POD using linguistic variables and MCIs of corporate sustainability and a Boolean analysis based on GRI's indicators. POD was defined as the extent to which disclosures are perceived as comprehensive to the users. Therefore, POD is not capable of perceiving how sustainable and responsible a company has been. Consequently, Future studies can evaluate corporate responsibility and sustainability performance using linguistic variables.

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Appendixes:

A) Linguistic Perception of Economic and Governance Criteria using Crisp and Fuzzy Numbers

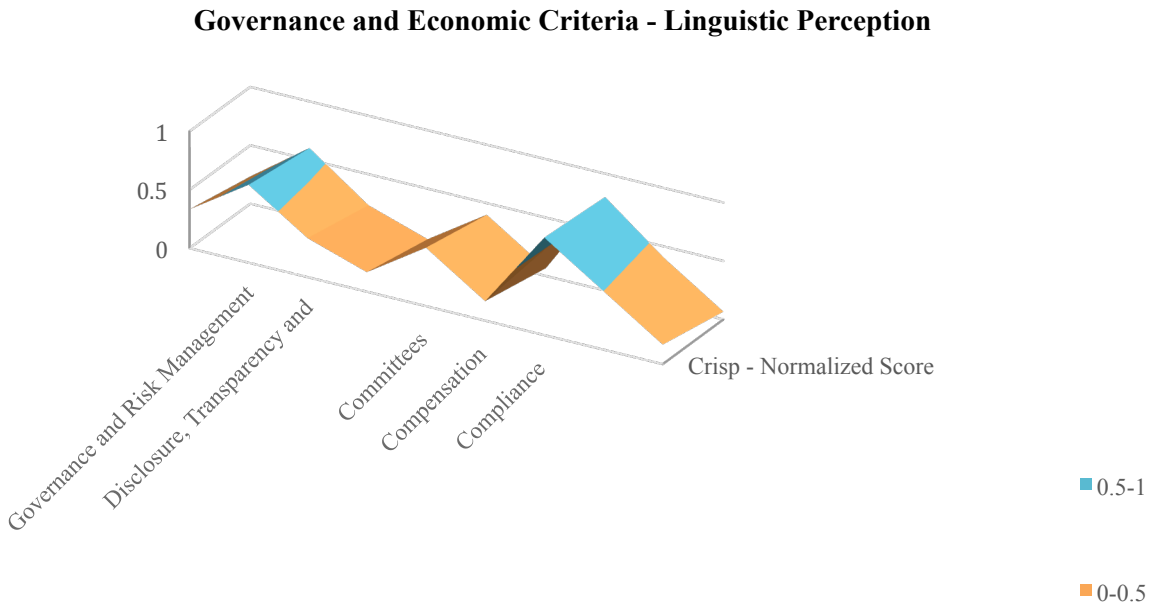

Figure A - Linguistic Perception of Economic and Governance Criteria

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B) Linguistic Perception of Social Criteria using Crisp and Fuzzy Numbers

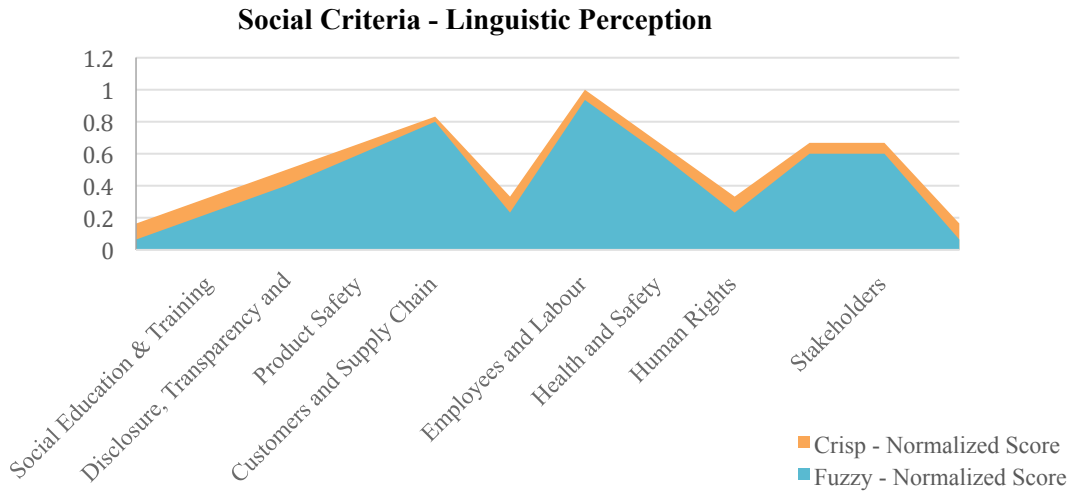

Figure B - Linguistic Perception of Social Criteria

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C) Linguistic Perception of Environmental Criteria using Crisp and Fuzzy Numbers

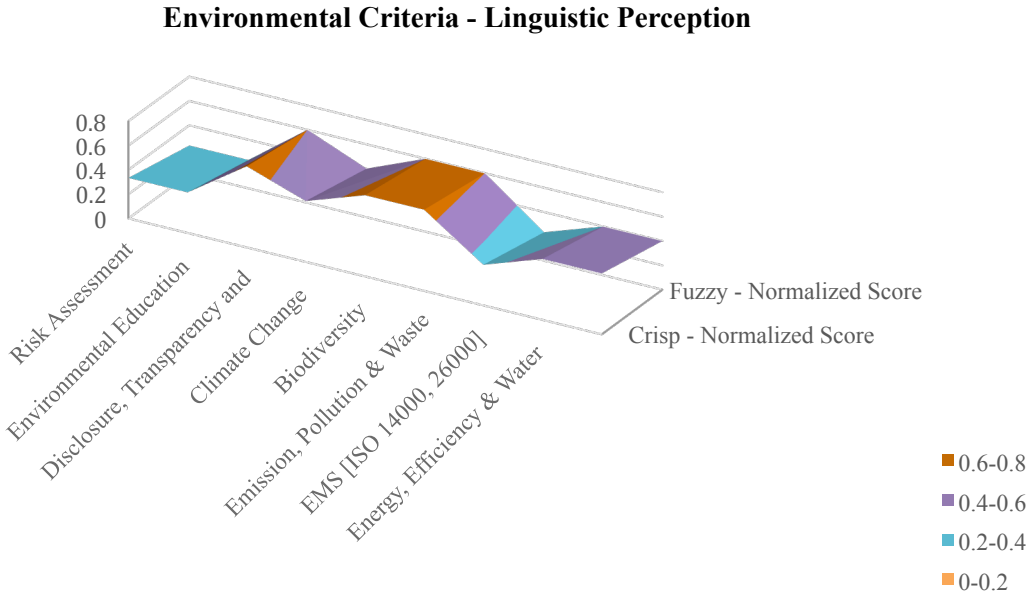

Figure C - Linguistic Perception of Environmental Criteria

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The Emerging Nature of American-Style Eminent Domain Regulations in China – A Case for Governance

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I. Introduction

The notorious *Kelo*[1] case decided by the United States Supreme Court in 2005 was one battle in the protracted war between government power on the one hand, and private property and individual liberty on the other. This conflict has taken place in other times and other places than America in the late twentieth century. Moreover, the strife continues, not only in America, but also in the People's Republic of China, where the conflict has intensified to the point where there has been civil unrest. The focal point of the conflict in *Kelo* was the government's power to take private property from its lawful owner and to transfer it elsewhere. This power of eminent domain has been described by some critics as "awesome," "despotic,"

[1] [
[2] []
[3] Chenglin Liu, *The Chinese Takings Law from a Comparative Perspective*, Washington University Journal of Law

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"abused," "overused," "sold to the highest-bidding special interest, breeding inefficiency and running roughshod over the property rights of untold citizens."[2] The aim of this paper is to suggest ways, both methodological and philosophical, to curb this potentially despotic power, especially where it has been manifested at the local government level in the People's Republic of China. The authors intend to examine the history of eminent domain law in the United States, in order to see if perhaps there are object lessons for the Chinese legal community.

Of course, the history, culture, and legal background of the United States and China are quite divergent. The United States has been deeply influenced by the English philosopher John Locke, both in the colonial period, and even today. John Locke taught that every human being was endowed with a natural right to property (as well as the right to life and liberty). This right to property had its origin in God, not the state. The state's subordinate role was to protect the individual's God-given right to property.[3] In America, property rights can well be called sacred.[4] China's view of property, on the other hand, is quite different. Because of the communist background of the modern Chinese state, it is widely believed in China that the rights to property derive from the state, and not from God (or natural law). Given this huge ideological gap, can China even consider the experience of the United

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2 []

3 Chenglin Liu, *The Chinese Takings Law from a ComparativePerspective*, Washington University Journal of Law and Policy, 333, 334 (2008)

4 "American people believe that property rights are invested with moral significance." [Sandefur at 711 at Liu, FN 357] "Private property is precious in American." [355 Baron, supra note 2, at 654 in Liu] "[S]ound protection of property rights is [deemed] fundamental to all other liberties." [358 Kochan, supra note 11, at 55. In Liu 333 or 334]

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States as helpful in dealing with the eminent domain problem's of the People's Republic?

We must first note that the ideological contrast we have just drawn between the two countries is actually too stark. For one thing, in America, there have been other views besides John Locke's. There is a strain of thought that holds that emphasizes the *economic utility* of private property, rather than the moral necessity of private property rights. As Posner indicates, "legal protection of property rights creates incentives to exploit resources efficiently."[5]This is a pragmatic view which impels a less strict approach to the protection of individual property rights. As we shall see, this view is much closer to the current view in the P.R.C.

In addition to the pragmatic strain that views private property in pragmatic, utilitarian terms, the history of American jurisprudence has witnessed a long-running ideological conflict between the Lockean view that the natural law is sovereign and dispenses property rights to the individual, with another view that holds that the government, not natural law, is sovereign. This latter view is associated with the English philosopher Thomas Hobbes and the English jurist Blackstone , who was so influential in the development of the American legal system. The Hobbes/Blackstone view is much closer to the Chinese view of property than is the Lockean view. Hobbes held that what the sovereign

[5] Posner, [see at FN 137 in Liu, p334 to get the cite]

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governmental power did was right by definition, and therefore it was impossible to argue that the sovereign government could act unjustly.[6] Blackstone proclaimed "that the power of parliament is absolute and without control."[7]This view began to eclipse the Lockean view in twentieth century America, and is especially apparent in the Progressive Era and the New Deal, when United States governmental power began to swell at the expense of individual liberty. The Hobbes/Blackstone view is remarkably close to the current political theory operative in the People's Republic of China today.

This paper will push for the proposition that legal and procedural reforms, while valuable, are likely to be ineffective either in the United States or China unless those reforms are planted in the soil of a thorough-going natural rights philosophy.

II. History of Eminent Domain in the United States Prior To *Kelo*

A. Two Competing Views

1. The Narrow View

The Fifth Amendment to the United States Constitution states that . The Takings Clause of that Amendment was incorporated through the Fourteenth Amendment

6 Timothy Sandefur, Mine and Thine Distinct: What Kelo Says about Our Path, 10 CHAPMAN LAW REVIEW 4 (2006-2007).
7 Quoted in Sandefur, Id., p6.

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and applied to the states in 1897.[8]The phrase "public use" in the Fifth Amendment has been ambiguously applied over time, and has been the subject of much interpretation and contention. Different phraseology has been used to describe what "public use" was supposed to mean; for example, "used by the public," "public advantage," "promoting the public welfare," "the public good," "the public necessity," etc.[9] For the sake of convenience, we may distinguish the cases by the way they interpret the phrase "public use," some of the cases adopting a narrow view of the phrase, and other cases adopting a broad view of the phrase.

Courts who adopt the narrow view interpret the phrase "public use" to mean "used by the public." This means that the public, through its governmental representatives, must use and have control over the condemned land for it to be properly a subject of condemnation. An easement for a power line, or a railway track, would fit this definition, as would a military arsenal built by a government.

2. The Broad View

On the other hand, a court using a broad view of "public use" would equate public use with "public advantage," "public utililty," or "public purpose." Any taking that can be shown to further public welfare, economic development, or which can be claimed to be a better use of local resources, would be considered by such a court to be a valid "public use" for the condemned land. This was true even if a private party received an incidental benefit from the forced transfer. The narrow view and

[8] [get name of case]
[9] David A. Schultz. ""What's Yours Can be Mine: Are there Any Private Takings After City of New London v. Kelo?" " *24 UCLA Journal of Environmental Law and Policy,* 198 (2006).

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broad view contended with supremacy throughout American legal history, until the broad view prevailed during the twentieth century. [10] During this period of contention, it should be noted, the broad view was the dominant view.[11]

There are several reasons the broad view prevailed. One reason is that it was very difficult for the courts to come up with a rigidly bounded definition for public use. The courts tried various formulations. Did the public retain control of the property? Was the public permitted access or use of the condemned property? Did a certain number of individuals benefit? Did no private parties benefit? Many of the tests attempted were somewhat subjective, and the fact situations were so varied as to make a rigid rule impractical to discover. The fact situations were often dependent on the geographical situation of the land to be condemned – an irrigation ditch was much more likely to be of "public use" in a dry western state or territory than it would be in an eastern state with plenty of rainfall.[12] The second reason that the broad view prevailed was that there were many social and economic necessities that compelled the use of condemned property, whether it was a mill or a railroad that needed to be built, or a slum that needed to be cleared, or a military installation to defend the country. These necessities pressured the courts to expand the definition of "public use" until the broad view prevailed. The broad view prevails at the present time.[13]

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[10] *Id.* at 198, 199. [ck 199]
[11] Charles E. Cohen, Eminent Domain after Kelo v. City of New London: An Argument for Banning Economic Development Takings, 29 Harvard Journal of Law & Public Policy , at 500 (2005-2006) .
[12] Shultz, *Id.* at 198, 199. [ck 199]
[13] *Id.* at Shulz p10, look it up]

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B. Evolution of Eminent Domain in the USA prior to *Kelo*

1. Pre-Colonial and Colonial Periods.

It is significant that during seventeeth century, and during the first part of the eighteenth century, before the U.S. Constitution existed, there is an "abundant" evidence of takings in which colonial courts used a test for legitimate takings that would only satisfy the modern broad view.[14]

2. First half of the Nineteenth Century

As a result of the vagueness of limitations on the power of eminent domain, courts in the early nineteenth century developed limitations of the taking power piecemeal, decision by decision, in the state courts. The state courts lacked guidance, and so turned to civil law, natural law, and common law for guidance. The influence of natural law can be seen in this period. Just as the term "just"[15] which is used in the Fifth Amendment to the U.S. Constitution implies a higher standard of natural law, so also the U.S. Supreme court in *Wilkinson v. Leland*, 27 U.S. (2 Pet.) 627, 658 (1829) stated: "We know of no case, in which a legislative act to transfer the property of A to B, without his consent, has ever been held a constitutional exercise of legislative power in any state of the union. On the contrary, it has been constantly resisted as inconsistent with *just* principles, by

[14] Cohen, *Id.* at p532 .[ck]
[15] [get exact language of the Fifth Amendment]

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every judicial tribunal in which it has been attempted to be enforced." Philip Nichols, Jr. concluded that apparently the state courts developed the doctrine of "public use" be reference to the "higher law," and by reference to the phrase found in the Fifth Amendment, and in many state constitutions, which stated that "nor shall private property be taken for public use without *just* compensation."[16]

At the first of the nineteenth century, government takings were chiefly for roads and dams. As the nineteenth century progressed, economic necessities impelled the courts to more and more use the power of eminent domain. This could be seen especially in takings for mills and railroads. The Mill Acts allowed governments to condemn riparian property to create grist mills, which caused other landowners' property to be flooded and rendered worthless. Railroads were perceived to be of huge economic benefit, and more and more land was taken to provide the railroads rights-of-way for their tracks. These takings were not for public roads and dams, but rather for private corporations whose functions were considered to provide a public benefit. In addition, the types of mills that were being created by condemnations were broadened to included lumber mills, cotton mills, pulp mills, or foundries, all of which were obviously not for "use" by the public. Thus the definition of "public use" became broader. The taken land was not owned by the public, but a private corporation whose operations supposedly provided a public benefit. The courts sometimes restricted this type of condemnation to those in which the taken land was used by what today would be called a common carrier, obligated to serve all members of the public. But lumber mills, cotton mills, pulp

[16] Philip Nichols, Jr., *The Meaning of Public Use in the Law of Eminent Domain*, 20 B.U. L. REV. 615, 616 (1940). [download this .pdf – what is full name of the law review?] (emphasis mine)

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mills, foundries, etc. obviously do not fall into that category. Nonetheless, courts repeatedly upheld condemnations for such private enterprises, by applying a broad definition to "public use."[17] Thus can be seen the early nineteenth-century struggle between a natural rights approach which protected the individual property owner and large economic enterprises which were favored in the name of economic development.

3. Second Half of the Nineteenth Century

In the first half of the nineteenth century, judicial decisions embraced both the natural rights approach and the economic development approach, the former decisions interpreting "public use" narrowly, and the later decisions interpreting "public use" broadly.[18] By the middle of the century, the courts had widely adopted a broad view of "public use" in order to favor economic development, and this produced a backlash on the part of courts who had become increasingly concerned that the institution of private property was being threatened, and that legislatures had become co-opted by powerful special interests who had no proper concern for the public good. These courts returned to a narrow view of "public use,' requiring that the members of the public actually use the condemned property. There is scholarly disagreement over how widespread this narrow view of "public use" became. At any rate, even where the narrow view was adopted, it was often more rhetorical than actual. There were several reasons for this. First, the use-by-the-

[17] Cohen, *Id.* at 504-506.
[18] Chenglin Liu, *The Chinese Takings Law from a Comparative Perspective*, Washington University Journal of Law and Policy, 326 (2008). Also see Cohen, *Id.* at 507.

public test was difficult to apply, forcing courts to examine to what extent the public should be allowed to use the property in order for the property to be considered publically used, or upon what conditions. Second, courts used loopholes, limitations, and evasions to avoid applying that narrow view of public use to which they gave lip service. The urgent needs of an on-marching industrialism impelled the courts to apply a broad definition of public use even as they claimed to uphold precedents which favored the narrow view. The tendency to permit liberal use of the eminent domain power reached a peak near the end of the nineteenth century.[19]

4. First Half of the Twentieth Century

By the first part of the twentieth century, the narrow view of the "public use" clause was, at best, a minority view.[20] Three distinct historical periods during this era impelled the courts to even more and more adopt the broad view of "public use." The first period was the Progressive era, the second period was the New Deal, and the third period was World War II.

[19] Cohen, *Id.* at 507-508.
[20] Cohen, *Id.* at 509.

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The Progressive Era.

There were four tenets of Progressivism which shaped the courts of the nineteen-twenties, and which encouraged the courts to aggrandize the power of the state over the individual in cases dealing with eminent domain. The first tenet was the rights, such as rights in property, were granted by the state, and not by God (or by "nature"). The second tenet was that the Constitution was a "living document," whose meanings changes whenever external circumstances demand. Therefore, concepts such as "public use" could change as the need for economic development became more urgent. The third tenet was that courts should not interfere in case legislatures restricted individual property rights. The fourth tenet was that government exists to shape society into the form that the collective desires, but government does not exist to secure individual rights, such as property rights. The Progressive attitude towards property rights quite naturally resulted in frequent violations of the rights of individuals. Previous generations saw private property as a natural right which government was obliged to protect, but the Progressives believed that private property was rather the mere creation of positive law. The state invented property rights, said the Progressives, and the state could change the rules governing those rights at will. It is not at all surprising that the use of eminent domain expanded during the Progressive era.[21]

[21]Timothy Sandefur, *Mine and Thine Distinct: What Kelo Says about Our Path*, 10 Chapman Law Review, 19-22, 25 (2006-2007).

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The New Deal.

The expansion of government power with regard to eminent domain continued into the nineteen-thirties. At the end of that decade, the Supreme Court had almost entirely abandoned the Lockean ideal of individual property rights. The legal theorist Roscoe Pound said the books of the day were "full of theories when carried out lead to… an omnicompetent state in which the individual is submerged.[22] In 1940 The Court announced that it would not intervene to protect aggrieved individual property holders when a legislature over-aggressively condemned private land.[23]

World War II.

Many takings during the war occurred for military and war-related purposes. For example, controlling the rent of a leased building, an emergency war time measure, was considered a valid "public use."[24] In Old Dominion v. United States, the U.S. Supreme Court held that taking of land for military purposes was a valid public use justifying the condemnation.[25] In International Paper Company v. United States, the U.S. Supreme Court sanctioned the taking of electrical power from the Niagra Falls Power Company and diverting it to other companies for war purposes.[26]

[22] Roscoe Pound, *ContemporaryJuristic Theory*1, 1940, quoted in Sandefur, *Id.* at 29.
[23] United States ex rel. Tennessee Valley Authority v. Welch [get date, and rest of cite], quoted in Sandefur, *Id.* at 29.
[24] [Shultz, FN 72]
[25] [Shultz, FN 74]
[26] [Shultz, FN 75]

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5. Second Half of the Twentieth Century

Three Critical Cases Before Kelo. The three most important eminent domain cases decided before Kelo and cited often therein, were Berman v. Parker, 348 U.S. 26 (1954), Poletown Neighborhood Council v. City of Detroit , and Hawaii Housing Authority v. Midkiff, 467 U.S. 229 (1984). All three cases adopted the broad view of "public use." Two of the cases authorized the taking of private land from a private landowner and the transfer of it to private developers. Because almost all discussion of United States eminent domain law includes these three cases, a brief synopsis of them will be given below.

In Berman v. Parker, the aggrieved landowner owned property upon which was built a department store. The store was not blighted; however, it fell within the confines of a district which the landowner's city had declared blighted. The city took the department store and transferred it to a private developer, for the purpose of eliminating blight, notwithstanding the non-blighted nature of the store. The U.S. Supreme Court upheld the taking.

In Poletown Neighborhood Council v. City of Detroit, the city of Detroit condemned an entire ethnically cohesive neighborhood, a non-blighted neighborhood, in order to transfer land to General Motors for an assembly plant. The Michigan Supreme Court claimed to act with "heightened scrutiny" because the transfer was from one private party to another; nonetheless, the taking was

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approved by the court. The justification for the taking was not the elimination of blight; rather, it was economic development. The neighborhood was destroyed; however, the promised material benefits to the city never materialized. Two decades after Poletown was decided, the case was overturned by the Michigan Supreme Court in County of Wayne v. Hathcock , a rare limitation on the taking power, and therefore worthy of note. One writer noted that the reversal of Poletown was accompanied by "near-unanimous scholarly applause" that Poletown had been "smashed into oblivion."[27]

The facts in Hawaii Housing Authority v. Midkiff were somewhat unusual; however, the legal findings of the case contributed to the continuing augmentation of local governments' taking powers. In this case, the state of Hawaii argued (very questionably) that an oligopoly existed in the real estate market in that state, because 47 percent of the state's land was held by 72 private landowners. The state proposed to remove title from the alleged oligopolists and sell the land to the general public. The court held that ending an oligopoly was a "public purpose," and that the taking was valid.

Thus we see that the law was very clear at the time of the *Kelo* decision in 2005. Condemnation of private land and transfer to other private parties was condoned by almost all courts, as long as the taking power could assert any sort of rational reason why a public purpose might be served by the taking. This was the situation

[27] Lee Anne Fennell, *Taking Eminent Domain Apart,* Michigan State Law Review 957,958 (2004) [check exact page number]

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when the U.S. Supreme Court took up the *Kelo* case in 2005. The case should have been a routine one. It was anything but routine. When the *Kelo* court followed precedent and allowed a city government to take a homeowner's house and transfer it to a developer, the ensuing uproar shocked almost everyone. Thus it is necessary to look at the *Kelo* case, not only in order to understand the current state of U.S. law of eminent domain, but to observe an embryonic pushback against the ever-expanding powers of governments condemning the private property of their citizens.

III. The Kelo Case

A. The Factual Setting

The city of New London, Connecticut condemned a ninety-acre tract of land that contained the non-blighted homes of Suzette Kelo and other homeowners. The city intended to create a development that would include a waterfront hotel and conference center, marinas, a public walkway along the river, residences, a Coast Guard museum, offices, and parking. The planned development also included space for a research and development park conveniently located next to a research facility recently constructed by Pfizer, Inc., a large pharmaceutical company. The city claimed that New London's public would benefit greatly, because, claimed the city, roughly 1,200 to 2,300 permanent jobs would be created, and property taxes derived from the project would be between roughly $680,000 and$1,200,000

annually. These prophecies failed, however. As of the beginning of 2010, the original Kelo property was a vacant lot, generating no tax revenue for the city, the developer having failed to obtain financing. The final cost to the city and state for the purchase and bulldozing of the formerly privately held property was $78 million. The promised new jobs and up to $1.2 million a year in tax revenues did not materialize. Pfizer, Inc. closed its large research facility next to the condemned property. The land was never deeded back to the original homeowners, most of whom left New London for nearby communities. The taken property eventually became a vacant lot, which the city then used for a trash dump.[28]

The benefits which were promised to occur after the condemnation offer quite a contrast to what actually happened. Suzette Kelo and her co-appellants lost their houses, the taxpayers lost 78 million dollars, and the city gained no jobs and no tax revenue. The city did, however, gain a garbage dump.

B. Justice Stevens' Majority Opinion

Justice Stevens' majority opinion can be summarized with five propositions. The first holding was this: a government may take land from one private party and bestow it on another private party, even if the purpose is for "economic development." Suzette Kelo had tried to distinguish a taking for blight from a taking for economic development, arguing that even if the former is a proper

[28] "Kelo v. City of New London," http://en.wikipedia.org/wiki/Kelo_v._City_of_New_London, accessed May 5, 2012.

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"public use," the latter is not. The court disagreed, and succinctly contradicted the oft-quoted nineteenth century maxim that to transfer the private property of A to a private party B, without his consent, is inconsistent with just principles.[29]

The second holding of the majority opinion tried to put some kind of limit on the government taking power. Even though the transfer was for a "public use," and "public use" was defined by the court very broadly to include economic development by private developers, nonetheless, there must be some minimal showing of public purpose. A naked transfer from A to B would not pass constitutional muster.[30]

The third holding of the majority opinion stated that in order to define that minimum standard of public use, great deference should be given to the state legislatures. The courts did not have the expertise to decide such questions. This continued the tradition of the court, since the passing of the *Lochner* era, to refuse to protect natural rights (substantive due process rights) of individuals, whose rights had been transgressed by legislatures. Justice Stevens wrote that states could define public use very broadly; or, rather they could legislate that "economic development" is not public use, and could thus entirely prohibit takings for economic development.[31]

[29] Wilkinson v. Leland, 27 U.S. (2 Pet.) 627, 658 (1829)
[30] [get cite]
[31] [get cite]

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The fourth holding of the majority of the court seemed to suggest that a "well-developed plan or scheme for public improvement" is enough to show public purpose. This is a very minimal standard for defining "public use," because any taking for economic development will be pursuant to a "well-develop-ed plan." However, some have claimed that a new standard for the limitation of the taking power can be discerned in the requirement for a well-developed plan or scheme.[32]

The fifth holding of the majority opinion stated that it was not necessary for the developer in an economic development taking to show that economic benefits will actually occur. The developer need merely to assert that they might occur.[33] This holding has become somewhat ironic, given that the condemned land in *Kelo* did not, in fact, transform into the upscale urban development that was promised, but rather ended up a trash dump.

C. Justice Kennedy's Concurring Opinion

Justice Kennedy, in concurring with the majority of the court, focused on the contention by Suzette Kelo and her fellow petitioners that if "public use" is defined to be "economic development," then there is no effective restraint on a government prohibiting it from taking any property it wants for any reason it wants. This was also a major concern of dissenting Justice Sandra Day O'Connor. Justice Kennedy rejected these concerns, saying that a government could not easily use "economic

[32] David A. Schultz, ""What's Yours Can be Mine: Are there Any Private Takings After City of New London v. Kelo?" " 24 *UCLA Journal of Environmental Law and Policy,* 195 (2006).
[33] [get cite]

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development" as a pretext to take property from one citizen to give it to another citizen, the latter having gained undue influence with the local government through personal and political connections. Justice Kennedy pointed to certain categories of evidence which would show there was a true public purpose: testimony from the government and business leaders involved in the plan, evidence of correspondence between the government and the developer, actual evidence that the city was in poor economic circumstances, that the state committed money to the project before particular developers were identified, that a variety of plans were considered, that the developer was chosen from a group of candidates, that other private parties (besides the developer) who might benefit from the development are unidentified at the time of the taking (for example, lessees of vacant buildings in the development).[34]

D. The Dissenting Opinions

1. Justice Clarence Thomas

Justice Thomas' rather straightforward dissent expresses his view that Midkiff and Berman were wrongly decided, and should be overturned. He suggested that "something has gone seriously awry with this Court's interpretation of the Constitution."[35] He advocated an originalist interpretation of "public use." When the words "public use" were penned by the drafters of the Constitution, the words

[34] [Cohen, p522. Get the original cite from *Kelo*]
[35]

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meant that the public would actually use the property, not that they public would received some sort of nebulous public benefit. Midkiff and Berman were "part of a string of… cases construing the Public Use Clause to be a virtual nullity, without the slightest nod to its original meaning." [36]Thomas expressed the Lockean view that "property is a natural, fundamental right, prohibiting the government from 'tak[ing] property from A and giv[ing] it to B."[37]

2. Justice Sandra Day O'Connor

Justice O'Connor's dissent, which has become prominent in the legal literature, makes three main points. The first is that *Kelo*, she claims, breaks new legal ground, and overthrows legal precedent which limits the government's taking power. This is a somewhat surprising position. The view of many commentators (and the view of the authors of this paper) is that *Kelo* actually follows precedent closely, and as Justice Thomas put it, is merely one of "a string of… cases construing the Public Use Cause to be a virtual nullity."[38] That string of cases includes Berman and Midkiff, which Justice O'Connor tries to distinguish from *Kelo*. In those cases, she opines, the government was taking property to stop an "affirmative harm," which was not the case in Kelo. In Berman, the taken property was "blighted," and thus causing an affirmative harm to the city, and in Midkiff, the alleged oligopoly was causing an affirmative harm to the Hawaiian real estate market. The governments in those cases used their police power to stop the

[36] []
[37] [Kelo, get page number, quoting Calder v. Bull, 3 U.S. (3 Dall.) 386, 388 (1798)]
[38] [See FN 34 above]

affirmative harm, and the taking was merely incidental to that police power. The taking itself, the exercise of the police power, is done for "public use," and thus satisfies the Public Use clause. What the governments did with the property thereafter was of no concern.[39] Justice O'Connor's line of reasoning here failed to convince her fellow dissenter Justice Scalia, who noted that the distinction between eliminating harm through the police power and conferring benefits through economic development was a distinction that was often merely in the eye of the beholder.[40] The majority opinion also expressed skepticism, noting that several of the Court's earlier decisions sanctioned condemnations of property which in no way could be considered harmful.[41]

Justice O'Connor's second main point was that takings for economic development for the most part redistribute wealth from the poor to the rich. She wrote that "[T]he beneficiaries are likely to be those citizens with disproportionate influence and power in the political process, including large corporations and development firms. As for the victims, the government now has license to transfer property from those with fewer resources to those with more."[42] This part of Justice O'Connor's dissent is difficult to refute. In one commentator's opinion, Justice O'Connor was "undeniably correct."[43]

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[39] [Sandefur, Mine, p45]
[40] [Cohen, p525]
[41] [p525]
[42] [Cole,pp13-14]
[43] Daniel H. Cole, *Why Kelo is not Good News for Local Planners and Developers,* Georgia State University Law Review, 13 (2006)

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The third point that Justice O'Connor made in her dissent is one which has been used as a rallying cry for property rights advocates, in the midst of the fevered reaction to the *Kelo* decision. Justice O'Connor declared that takings for economic development effectively rubbed out the distinction between public and private use of property, thus rendering the Public Use Clause void. If the only thing a private developer has to do is to claim that there is some sort of incidental public benefit accruing from the developer's private use of the property, then, of course there will always be such a public benefit when a private entity derives private benefit from taken land. Thus, even when the taking produces a huge private benefit to a developer, even though the public benefit is very small, the taking under the majority decision will nevertheless be justified, and thus the Fifth Amendment really means nothing when it says a taking must be for "public use." Justice O'Connor wrote that "all private property is now vulnerable to being taken and transferred to another private owner, so long as it might be upgraded – i.e., given to an owner who will use it in a way that the legislature deems more beneficial to the public."[44]

E. Brief Analysis of the *Kelo* Case

It should be noted that *Kelo* was heavily criticized by scholars, with very little support given to the majority opinion.[45] Much of that criticism in contained in

[44] [get cite]
[45] Jianlin Chen, *China's 'Ding Zi Hu', U.S.'s Kelo and Singapore's En-bloc Process: A New Model for Economic Development Eminent Domain from a Givings Perspective*, 24 Journal of Land Use & Environmental Law, 107 (2008).

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Section IV of this paper, *From Narrow To Broad: Four Possible Positions On Takings*. However, at this point several key questions should be quickly noted in passing. First, was the case properly decided as a matter of law? Most legal commentators, the five justices in the majority, and at least two dissenting justices thought that the case was, indeed, properly decided according to precedent., despite Justice O'Connor's opinion to the contrary.[46] A more interesting question, however, is whether the case was decided properly according to *economic benefit* to the city of New London. An even more interesting question than that, is whether the case was decided properly according to *justice* to Suzette Kelo and her co-petitioners?

That the city spent 78 million dollars in order to obtain the condemned land, and ended up with a trash dump that provided no jobs and no tax revenue for the city's citizens, seems to answer the first question very well. What of *justice* for Suzette Kelo and her evicted co-petitioners? That she did not consider the compensation offered her "just" may be inferred from the fact that she fought the city of New London all the way to the United States Supreme Court. Was she unreasonable in her demand that she keep her own house, or was she deprived of her basic human right of the right to property? The court deferred to the state legislature, and would not inquire into whether petitioners rights were violated. This, of course, was in accord with the Court's long-standing practice since the New Deal, to defer to state legislatures when an issue of a citizen's natural right is allegedly infringed upon by

[46] []

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the legislature. The court's majority reflected the view of Blackstone that the legislature is supreme, and rejected the Lockean view that natural rights are paramount. In fact, a look at the cases cited by the majority and dissenting opinions gives evidence that *Kelo* is a paradigm for that fundamental conflict in American legal philosophy – the Blackstone view that the legislature is supreme versus the Lockean natural rights view. The majority opinion quoted from

We should consider whether the *Kelo* case continues broadening the scope of justifiable takings for public use, leaving property owners subject to "the specter of condemnation hang[ing] over all property?"[47] Or does *Kelo* mark the highwater mark of the takings power of municipal and state governments, and does it provide leverage against the expansion of the power of eminent domain? Many property rights advocates, quoting Justice O'Connor's impassioned dissent, felt that *Kelo* was a disaster, and that after *Kelo* no real limitation existed on the power of governments to take the land of individual property owners. [48]However, some property rights advocates were not so pessimistic, noting that four of the nine justices dissented, which was unusual for a case in which precedent was so clearly in favor of the majority. [49] In addition, the majority opinion left large discretion to the states to regulate condemnation for economic development, should the states so desire.[50]

[47] [O'Connor]
[48] []
[49] []
[50] [Kelo]

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F. The Kelo Backlash

The states, as a matter of fact, did take advantage of the Justice Stevens invitation for state legislatures to decide the limits of eminent domain. The states were pushed by the huge public backlash against the *Kelo* decision, a backlash that was entirely unforeseen by the legal community. One legal commentator wrote that "[A]ll hell broke loose. The political controversy that erupted around *Kelo* took legal scholars by surprise. After all, the decision did not significantly alter eminent domain doctrine; the Court simply followed well-established precedents. But Justice O'Connor's hyperbolic dissent inflamed property-rights advocates, media pundits, and state and federal legislators, who assailed *Kelo* as the death knell for private property rights."[51] As a result of this pressure, since *Kelo* a majority of states enacted or considered legislative or constitutional measures to further restrict eminent domain. Some of these enactments or proposals were mere window-dressing, pushed forward to assuage public anger, and offered no real protection against eminent domain for economic development, or eminent domain for blight. Much opposition from mayors, developers, and economic development officials bogged down the progress of legislation aimed at limiting the power of eminent domain. However, a few of the enactments were quite significant.[52]

The legislative and constitutional proposals suggested by states after *Kelo* to restrict eminent domain were quite diverse. One state, the state of Florida,

[51] Cole, *Id*. at 1.
[52] Cole, *Id*. at 25,26,38.

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explicitly outlawed eminent domain for blight as well as for economic development. Some states have banned eminent domain for economic development, but continue to allow condemnations for blight. Some states that still allow condemnations for blight nonetheless more narrowly defined the definition of "blight." Some states tightened up the definition of blight by refusing to allow a government to designate a non-blighted building as blighted merely because it is located in an area designated as blighted.[53] Therefore, ironically, after *Kelo*, the eminent domain power of American states and municipalities has been at least marginally diminished.

IV. From Narrow To Broad: Four Possible Positions On Takings

Using the history of American eminent domain law as a guide, takings can be placed on a continuum, starting with the view that is most restrictive of government power, moving to the view that is most expansive. The most restrictive view would be to outline eminent domain entirely. The next most restrictive position would be to restrict takings to lands that are for "public use," with "public use" being narrowly defined such that the public, or a common carrier regulated by the government, owns the property. This second category of takings would include land taken for military or other government installations, and would also include public roads, reservoirs, dams, etc. Also considered in this second category would be common carriers, who, although privately owned, nonetheless are heavily

[53] Cole, *Id.* at 15-17.

regulated by governments, and whose services cannot be refused to anyone in the public. The third position would include all the takings in the the previous position, and would add takings for blight. The fourth and most expansive position would include all takings in the previous two positions, and would add takings for economic development.

A discussion follows which will examine the advantages and disadvantages of each position, considered from several aspects, such as justice for the landowner, and utility for the government and the public.

A. Eminent Domain Should be Outlawed

To adopt the most restrictive view, outlawing eminent domain entirely, has not been advocated even by fervent property-rights defenders, and was not considered even by Justice Thomas, whose views on eminent domain were the narrowest on the Court. However, a discussion contemplating complete abrogation of the government's taking power, while merely theoretical, nonetheless focuses the mind on the costs, as well as the advantages of eminent domain in general. The fundamental rationale for eminent domain is well known. Sometime's public enterprises cannot be completed should a holdout refuse to sell. For example, if a power line or railroad has to stretch from Point A to Point B, and a holdout between Point A and Point B refuses to sell, the whole enterprise therefore becomes worthless. Absent eminent domain, theoretically a power company or

railroad could buy land secretly, to keep the holdout from knowing the hostage value of his property. However, given that public utilities and common carriers require public openness, buying secretly is not an option. Therefore, eminent domain would seem to be necessary.[54]

However, even if it be granted that eminent domain in certain instances is necessary, there are definite costs and problems involved. The first cost is to the landowner, who is often undercompensated, despite the Fifth Amendment's command that compensation be just. For example, compensation is usually based on fair market value of the condemned property, not the replacement value. If a landowner loses his home, he will often not be able to find a comparable home at the same price. In addition, if the condemned homeowner's home satisfies unique needs, such as wheelchair access, a replacement home might be difficult to find. Also, the small business owner, to whom location might be a key ingredient to his business' success, may not be able to find another location which will make his business a success. [55]

In addition to costs to the landowner, there are costs to the government. There are procedural costs, such as drafting and filing formal judicial complaints, service of

[54] Ilya Somin, *Controlling the Grasping Hand: Economic Development Takings after* ***Kelo***, 15 Supreme Court Economic Review (1), 25 [get page number from Somin .pdf25, from 183-271] (2007).
[55] Jianlin Chen, *China's 'Ding Zi Hu', U.S.'s Kelo and Singapore's En-bloc Process: A New Model for Economic Development Eminent Domain from a Givings Perspective*, 24 Journal of Land Use & Environmental Law, 123-124 (2008).

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process, professional appraisal services, public hearings on the legality of the taking, public hearings on the compensation required, and costs of litigation.[56]

B. Condemned Land Must Be for "Public Use" Strictly Construed

The second possible position a jurisdiction might take concerning condemnation is the next most restrictive one, a view that states that a condemnation should only be allowed for "public use" strictly defined, where the government either actually owns the land, or a government-regulated common carrier owns the land. In other words, the property in question must actually be controlled by, and hence available for actual use by the general public. This is the position we have labeled above as the "narrow view." This was Justice Thomas' position in his *Kelo* dissent. Thomas claimed that this was the original intent of the Framers when they wrote "public use." This is a reasonable position. At least some legal commentators agree with Justice Thomas, and also claim that American courts honored this restrictive usage of "public use" for some years after the founding of the Constitution.[57] Others, however, claim that there is almost no direct evidence one way or the other concerning the Framers original intent when they wrote "public use."[58] Whichever

[56] [go to Liu, p303 to get Merrill cite]
[57] David A. Dana, The Law and Expressive Meaning of Condemning the Poor after Kelo, 101 Northwestern University Law Review Colloquy, 8 (2006). Dana cites Roger Clegg, Reclaiming the Text of the Takings Clause, 46 Supreme Court Law Review 531, 542–43 (1995) and Matthew P. Harrington, "Public Use" and the Original Understanding of the So-Called "Takings" Clause, 53 Hastings Law Review 1245, 1245–49 (2002) as writers who support the strict view of "public use."
[58] Dana, *Id*. at 8 [ck]. Dana cites Buckner F. Melton, Jr., Eminent Domain, "Public Use," and the Conundrum of Original Intent, 36 Natural Resources Journal 59 (1996) and David A. Dana & Thomas W. Merrill, *Property:Takings* 8-25 (2002) in support of the contention that a strict originalist sense of "public use" cannot be established.

position is true historically, the reality is that the Supreme Court has abandoned the strict definition of "public use." Were the Court to return to the strict definition, as Justice Thomas exhorted, then public takings would be subject to the same costs that an absolute prohibition would avoid (as mentioned above); however, takings would also accomplish the "public use" functions that eminent domain traditionally contemplated, such as public roads, dams, power lines, military installations, etc. The disruption to private ownership of property, which still existing, would nevertheless be miniscule compared to the dislocations brought about by takings implemented in order to remove blight, and those carried out in order to advance economic development.

C. Condemned Property Must Be Blighted

We next consider the third and fourth positions the courts and legislatures have adopted for eminent domain. These positions are the two more liberal views of "public use," which we have labeled above as the "broad" view. Using the scheme we have proposed, the third possible position which a court or legislature might adopt is that a taking for "blight" qualifies for a valid use for the government taking power. Of course, all takings that can be subsumed under position two, public use as narrowly defined, would also be permitted under this view.
Every problem that afflicts condemnations for economic development also affects takings for blight, and these problems will be addressed under the discussion of

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takings for economic development. However, there are a few problems that particularly effect takings for blight. One difficulty is that the concept of "blight" is "highly vulnerable to creative expansion."[59] The idea of blight seems to elide very quickly into "this property could be better used for economic development, and therefore the city deems this property blighted." However, for the sake of argument we may assume that a legislature may properly define blight, as for example, by listing certain housing code restrictions that may be found violated in the district to be condemned. Even in takings for blight, strictly construed, often much economic harm is done. The classic illustration of this is the urban renewal phenomenon of the 1940s, 1950s, and 1960s in America. "Such takings displaced hundreds of thousands of people and inflicted enormous social and economic costs, with comparatively few offsetting benefits. A recent study concludes that the use of eminent domain in 'urban renewal programs uprooted hundreds of thousands of people, disrupted fragile urban neighborhoods and helped entrench racial segregation in the inner city.' By 1963, over 600,000 people had lost their homes as a result of urban renewal takings. The vast majority ended up living in worse conditions than they had experienced before their homes were condemned, and many suffered serious nonpecuniary losses as well. More recent blight condemnations have inflicted similar harms on communities and poor property owners."[60]

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[59] Ilya Somin, *Controlling the Grasping Hand: Economic Development Takings after Kelo*, 15 Supreme Court Economic Review (1), [pg?] (2007)
Vol. 15, No. 1 (February 2007), pp. 183-271 Somin, p89 – why does mynotes say p89, but article is 183-271
[60] Somin, *Id*. at 92 [but ck page number problem]

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Another problem with takings for blight is that they are particularly aimed at the poor, who are least equipped to resist power developers in cahoots with local governments operating unjustly. This is especially true for those jurisdictions who tighten their definition of blight so as to exclude middle-class neighborhoods from a blight designation. And finally, another difficulty with takings for blight is that many statutes allow taking non-blighted properties if those properties are located in a *district* that is declared blighted. In other words, the government does not have to declare a particular property blighted in order to seize it; rather, the government must merely declare the area around the property blighted, and the non-blighted property may then be condemned.

An argument may be made that a government must be allowed to deal with blight, if for no other reason than for public safety. Even granting the argument, nonetheless it is not necessary to give the government the power to condemn a blighted neighborhood. Other tools are available to the government, such as the application of nuisance law, the enforcement of housing codes, and tax abatements (or subsidies) to encourage improvement of the property.[61]

There are many other difficulties with takings for blight, but these difficulties also occur in takings for economic development, and so will be considered in the next section.

[61] Somin, *Id*. at 95. []

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D. Takings for Economic Development

The definition of "public use" which provides for the greatest exertion of government power, and which has the potential for the greatest destruction of an individual's property rights, is one which states that "public use" is "public benefit by economic development." In takings of this kind, the objections to the eminent domain power reach their full force. Of course, a jurisdiction which adopts this approach also allows takings for "public use" strictly construed, and also takings for blight. However, when the taking power is exercised in a condemnation for economic development, explosive social forces are set into motion to a greater extent than in the case of the lesser included condemnations. This section will examine in detail the severe costs, mostly to the individual property owner, entailed by this kind of condemnation. Although this discussion will be limited to costs observed in American condemnation cases, the reader will observe that the discussion is easily generalizable to takings for economic development by any government anywhere, and in particular, to the current takings in China, which will be discussed at the end of this paper. We have categorized the costs as follows: 1) eminent domain for economic development is economically inefficient, 2) social costs, 3) procedural unfairness for property owners, 4) property owners are continuously subject to government power unlimited by law, 5) residential owners and nonprofits are especially vulnerable, 6) costs to taxpayers whose land is not condemned, 7) local governments become captive to special private interests, and 8) owners of condemned land are undercompensated.

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1. The Costs of Takings for Economic Development Eminent Domain for Economic Development is Economically Inefficient. Instead of providing goods and services and creating wealth, private entities with resources spend those resources on trying to obtain advantages from the government, at the expense of others. They expend their resources on activities such as lobbying (or perhaps illegal corrupt activities), and wining-and-dining legislatures, rather than creating wealth in the free market.[62]

Social Costs. Legal commentators who spend much time considering legal and economic abstractions can easily forget that it is real humanity being forcibly evicted from their homes. Often in condemnation cases courts will refuse to even consider the human costs, the social costs, of the condemnation.[63] But the social costs are high, and evoke strong feelings on the part of displaced property owners, as the aftermath of Kelo displayed, and as the dingzihu in China are now telling the world. The factual circumstances surrounding the infamous Poletown case can serve as an example of these emotions. The residents in Poletown, United States citizens who were loyal to their unions, who had built up tenure in their auto plants, who patriotically had fought in U.S. wars, were "rejected, ignored, and robbed by the very institutions through which they claimed their identities…[T]hese same people broke free of the illusion of civility that these institutions carry as trappings…"[64] "The residents of Poletown, like so many other victims of eminent domain abuse, came to see democratic government not as a system of mutual respect and participation toward

[62] [I think it's Somin, find it]
[63] Somin, *Id*. at 5.
[64] Sandefur, Mine, p38]

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a common good, but as a machine destroying their homes, their family heritage, and their community."[65] The psychological despair that eminent domain evictions create has been well-described: "[P]eople… are pushed about, expropriated, and uprooted much as if they were the subjects of a conquering power. Thousands upon thousands of small businesses are destroyed… Whole communities are torn apart and sown to the winds, with a reaping of cynicism, resentment and despair that must be seen to be believed."[66] Advocates of eminent domain assume that displaced property owners are "justly compensated." But can any cash award compensate for the loss of home and community? In addition, the very condemnation process itself assumes that the homeowner's property is of inferior value, because the condemning power has conceived of a higher use for it. Such "dignitary harms" can not be compensated with cash.[67] Some property is so tied up with an individual's identity, that it is impossible to compensate its loss with cash. One commentator observed "if some object were so bound up with me that I would cease to be 'myself' if it were taken, then a government that must respect persons ought not to take it."[68]

[65] [Sandefur, Mine, p38]
[66] 74JANE JACOBS, DEATH AND LIFE OF GREAT AMERICAN CITIES 5 (1961), cited in Somin, 17.
[67] [Chen, p124]
[68] Margaret Jane Radin, *Property and Personhood*, 24 Stanford Law Review 1005 (1982). [ck pg #]

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Residential Owners and Nonprofits are Especially Vulnerable. Residential owners pay lower property taxes than businesses, and non-profits generally pay no taxes on their property. This means that local governments have increased incentives to take the property of residential owners and the property of non-profits, Should a developer replace taken homes or non-profits with businesses, tax revenues will go up for the city. This places residential owners and non-profit organizations at increased risk for condemnation.[69]

Costs to Taxpayers Whose Land is Not Condemned. This cost is seldom considered by courts who sanction takings for economic development. Taxpayers whose land is not taken nevertheless must pay the condemnation costs, and the compensation paid to the displaced properly owner. In addition, all of the businesses, non-profit institutions, and public buildings that used to exist on the condemned property, are no longer available to serve the general public.[70]

[69] [Somin, p8]
[70] [Somin, p34]

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Local Governments Become Captive to Special Private Interests. The Kelo case illustrates this well. The condemnations in that case occurred as a result of extensive lobbying of state and local officials by the large pharmaceutical company, Pfizer, Inc. Apparently Pfizer offered to build a new headquarters in New London in return for the condemnations, which were to be used to build a research facility next to Pfizer's facilities.[71]Local government officials in such circumstances can hardly be expected to represent the interest of powerless homeowners, or small business owners. This is especially true because the interests of condemnation targets are short-term, while those of big developers are on-going. Most people will never be subject to a condemnation process, and so the threat to them is speculative. They are unlikely to get motivated to block a speculative threat, and they are unlikely to motivate other property owners who are not presently undergoing condemnation proceedings. On the other hand, developers have a full-time, day-to-day interest in condemning property for profit. They will continue to influence local officials till they get what they want. [72]

[71] [Somin, p57]
[72] Sandefur, Backlash, 54.

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Owners of Condemned Land are Undercompensated. The Supreme Court has decided that "just compensation" equals fair market value, which is defined as what a willing buyer would pay in cash to a willing seller at the time of the compensation. The problem with this is obvious: the seller is not willing, else he would not have had his property condemned. It is not a free market determination of value when the transaction is negotiated while one party has a gun to his head. There are several reasons why a seller won't be "willing" to sell at the time of the condemnation. Perhaps there is no replacement property available, which would be especially true if the condemned property was unique in some way, as for example, property with a unique view, or which has been upfitted for a disabled owner. Maybe the property has extreme sentimental value. Perhaps the seller was holding the property on speculation, but now the condemnation deprives the seller the right to exercise his right to speculate. Perhaps certain costs keep the seller from being "willing" to sell. For example, search costs for finding comparable shops and services in the new location, costs and aggravation of moving, attorney's fees, lost business revenue or goodwill or going-business-concern value.73

[73] [Cohen, p538-539]

2. Suggested Safeguards for Economic Development Takings

"Heightened Scrutiny." The term "heightened scrutiny" comes from the Poletown case. The idea behind this is that when takings are for economic development, the courts should exercise especial care to see that there is a "clear and significant" public benefit arising from the condemnation, which public benefit would justify the private damage done to property holders. The idea is similar to academic proposals that the court impose "means-ends" tests, to make sure that the harm effected by the "means," the condemnation, is worth the cost in order to attain the "ends" of public benefit. Some propose special scrutiny when certain circumstances exists, such as where subjective values are high, when the property is transferred to a small number of people, or when the eminent domain power is delegated to a small number of people.[74]

There are two problems with "heightened scrutiny" or means-ends tests. The first problem is that almost any taking will withstand the heightened scrutiny, and therefore the test provides no real protection to property owners. Homeowners and not-for-profit organizations will never produce as much tax revenue as businesses in a new development built on condemned property. The second problem with "heightened scrutiny" or means-ends tests is that these tests give the condemning power a perverse incentive to make the scope of the condemnation larger, to make

[74] [Cohen, p557, citing Merril in FN417]

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sure that the "public benefit" is large enough to withstand the heightened scrutiny.[75]

Increased Compensation. In the discussion above it was demonstrated that fair market value undercompensates condemned property owners. It has been suggested that a formula can be found which can compensate a condemned property owner by a set amount above the fair market value, in order to make up for the losses the property-owner receives when he receives only fair market value.[76] There are several flaws in this approach. First, it is almost impossible to accurately calculate such a formula. Second, it is not only condemned property owners who are damaged, but also the taxpayers who have to pay for the condemnation, and who lose the benefit of the public buildings on the condemned property. The only way to prevent such taxpayers from being harmed is to absolutely prohibit takings for economic development. And third, if the formula is too high, property owners might actually lobby the political authorities to condemn their property, in order to make a windfall profit.[77]

[75] [Somin, p5, 28, 31-32]
[76] [Somin, p5, Cohen p 557]
[77] [Somin, pp 5,33]

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Stronger Judicial Review. On the federal level, the court in Kelo reaffirmed its desire to give state legislatures extreme deference in deciding whether a taking was for public use. However, the state legislatures may pass legislation that simply says that the court will decide whether the condemnation is permissible under the state constitution or state statutes, and the condemning authority will have no say in declaring whether the taking was for "public use."[78]

[78] [Cohen, p562]

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Restrictions on the Definition of "Economic Benefit." For example, a court or legislature can require that the projected economic benefit from the condemned land be "clear and significant," as the Poletown court required.[79] The problem with this is that it provides a perverse incentive for a municipality to take a larger area of land than they might have done before, in order to make sure the economic benefit is "clear and significant," thus infringing on even more property owners right to their property.[80] Another restriction that might be placed on condemning authorities is a requirement that the economic benefit can only be realized pursuant to a "integrated development plan," as was suggested by Justice Stevens in his majority opinion in the Kelo case. However, this is unlikely to serve as any sort of real restriction on condemnations, because almost all economic development takings are carried out as a part of some sort of integrated development plan. In fact, Justice Stevens cited a case as an example of an unconstitutional taking, and the taking in that case was implemented as a part of an integrated development plan.[81]

[79] [Somin, p56, FN 33]
[80] [Somin, p8]
[81] [Somin, p56]

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Requiring the Economic Development to be Actually Realized. It is understandable that courts are reluctant to require this. Economic conditions often change after court cases are decided. If a municipality promised 1200 to 2300 new jobs, as the City of New London did in Kelo, and some labor-saving machinery is invented after the court decision, the city could be forced by the court decree to do something economically inefficient – hire unproductive labor rather than install more productive capital. However understandable this is, because courts almost never require a taker to actually produce the economic benefit he promised, it becomes very easy for a developer merely to state airy projections of benefits, benefits which have little prospect of being realized, even though the affected property owners are actually damaged by the taking. In addition to this problem, it is greatly difficult for the court (or the developer) to correctly assess the projected benefits, and this problem is exacerbated by the usual long period of time between the condemnation and the conclusion of the development.[82]

[82] [Cohen, p544,545; Somin, pp9,13,35]

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Developers Can be Constrained by Political Action. It is often argued that in a democracy, citizens can put political pressure upon local officials who abuse their condemning power. This argument suffers when confronted with certain realities of local politics. First, the calculations of the costs and benefits of a particular project are extremely complex, and the average voter will not be able to know whether a project will be profitable or not. Unlike a traditional condemnation, which produces a tangible road or bridge, an economic development produces an alleged economic boost which is generalized, and not able to be seen.[83] Second, the time frame for completion of a development is often longer than the terms of elected officials. Therefore, officials can reap the political support of developers in the short term, and if the development fails, the officials responsible for the failure are likely not in office anymore, and are thus beyond the reach of the wrath of voters.[84] Third, owners of condemned property are likely to be poor or politically unorganized, or both, and not able to withstand the sustained political pressure brought to bear by developers.[85] Fourth, only a small portion of potentially affected property-owners are actually affected, and thus it is difficult for them to politically rally those who are only potentially affected by possible future condemnations.

[83] [Somin, p19]
[84] [Somin, p20]
[85] [Somin, p21]

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Fifth, some potential political opposition which would be expected from condemned property owners is attenuated by the compensation that the condemned property owners receive. Some of the property owners will take the compensation they can get, rather than fighting a political battle they are likely to lose. [86]

Interjurisdictional Mobility. Unjust actions by municipal governments are generally constrained by the ability of citizen's to "vote with their feet." If enough citizens leave, the city loses taxpayers and tax revenue. But in the case of unjust condemnations, a citizen may not vote with his feet, for the simple reason that he cannot take his real estate with him when he leaves. Therefore, interjurisdictional mobility is no real check upon the taking power of a municipality.[87]

[86] [Chen, p122]
[87] [Somin, p41]

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Procedural Reforms. Procedural reforms have been suggested as a means to protect property owners subject to condemnations. Examples of such suggested reforms are extra advance notice of condemnation proceedings, mandating a detailed report laying out the purpose for which eminent domain is to be used, requiring extensive public hearings to justify the contemplated condemnation, giving condemned property owners the opportunity to voice their objections to being displaced. It is argued that requiring the municipality and the developer to jump through a lot of procedural hoops will deter unjust takings.[88] Such reforms would no doubt help, but there are several reasons that these reforms will not fully protect property owners. First, the cost of the procedural reforms, instead of deterring developers from a condemnation, will be passed on to the taxpayers, and not born by the developers or their political allies in the municipal government. Taxpayers will never have the acumen to see what they are paying, because of the complex nature of takings cases, so they will not express displeasure by voting against municipal officials. The second reason such reforms are not likely to deter property owners much is because if the taking is large enough, the cost can be spread out over a larger condemnation proceeding. Judicial costs are relatively fixed, and it costs just as much to deal with condemnation procedures when 2000 properties are condemned as when 200 are condemned. Therefore, large takings are unlikely to be deterred.[89]

[88] [Somin, p36]
[89] [Somin, pp36-39]

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3. Eminent Domain is Not Necessary to Deal with Holdouts

It is very often assumed that without eminent domain power, real estate developments would never be built, because holdouts would keep the project from being built, after all other property owners had sold their property to the developer. The advocates of takings for economic development, even if they concede the damage that is done to individual property rights, may often resort to the argument that without the taking power, economic progress is impossible. This is an erroneous assumption. There are large-scale development projects all over America that were built without eminent domain.[90]

How might a developer proceed without the taking power at his disposal? First of all, it should be recognized that holding out is not a simple process, but requires accurate information and a high degree of negotiating, bargaining, and bluffing skills. The potential holdout can be deprived of the accurate information he needs if the developer simply operates in secret, using straw men, and buys up parcels a piece at a time without letting anyone know that a development is planned. The potential holdout will be offered a price without him knowing that a windfall could be obtained by holding out. Operating in secrecy has allowed developers such as the Disney Corporation to assemble land for Disney World in Florida without the use of eminent domain. Harvard University has repeatedly used this procedure for developments in Boston, and so have prominent developers in Las Vegas and West

[90] []

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Palm Beach.[91] Perhaps not all holdouts are strategic holdouts, perhaps some are sincere holdouts who are not trying to make a windfall profit, but who sincerely value their property more than the developer does. The developer may have to then pay a higher price than he expected, but the transaction would be fairly determined in the free market, with no coercion involved, and thus more sociably desirable. If the holdout refuses to pay, there are other options, such as building around the holdout.[92]

V. The Law of Eminent Domain in China

A. The Current Situation: Social Unrest

It is no secret that in China there is widespread unease over local government condemnations and evictions for economic development. In February 2000, 10,375 families filed a class action lawsuit challenging the Beijing government's decision to demolish and relocate their homes.[93] The construction of the Three Gorges Dam in led to the eviction of between 1.3 and 1.9 million people from their homes.[94] Researchers at the Chinese Academy of Social Sciences report that approximately 66.3 million agricultural workers lost their land between 1990 and 2002, a number expected to eventually rise above 100 million. The situation is said to have led to alarm at the top levels of the government that the nation's food supply is

[91] [Somin, pp23-24] See Somin, p. 26, for a discussion of "precommitment" strategies, another possible method developers without the power of eminent domain could possibly use.
[92] []
[93] [Liu, p317]
[94] [deng, p2]

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threatened.[95] A *China Daily* editorial estimated that 2.5 to 3 million farmers per year were losing their land.[96] In 2006, Premier Wen Jaibao said that land seizures by local officials were provoking mass rural unrest that could threaten China's national security and economic growth.[97] According to the Ministry of Public Security statistics, China experienced an amazing 87,000 incidents of social unrest in 2005, up six percent from 2004 and up fifty percent from 2003.[98] Most incidents of social unrest are reportedly as a result of illegal takings of real property.[99]The building stadiums for the 2008 Olympics in Beijing caused over 300,000 Beijingers to be evicted from their homes. In addition, other modernization projects in the city have caused the forcible eviction of an additional one million urban residents, all with little or no notice and with minimal compensation.[100] According to government statistics, over thirty million Chinese people have had their land taken away from them for economic development.[101] In 2010, almost one thousand middle class residents of Shanghai marched from Shanghai to Beijing to protest being evicted from their homes to make way for the 2010 Shanghai World Expo.[102]

Unjust eviction procedures have aggravated the unrest. Water and electricity is sometimes cut off to force reluctant homeowners to leave. Some residents claim

[95] [Phan, p627]
[96] [Phan, p628]
[97] [Rosato-Stevens, pp98-99]
[98] [Rosato-Stevens, pp98-99]
[99] [Long, p66]
[100] [deng, p2]
[101] [wang,
[102] [deng, p2]

that they have come home to find their homes demolished without warning. Some have reported that their homes were destroyed by arson. Sometimes demolition crews cry "Earthquake!" in the middle of the night to clear residents out of their home. At other times, crews will begin demolishing homes with the families still inside. Purportedly, there have been many accidental deaths during such evictions.[103]

The response by judicial and governmental authorities to date has not done much to assuage anger. The Chinese judiciary as of 2006 had not recognized a claim by an evicted property owner based on constitutional rights. Attempts to bring a civil suit or to petition officials often result in incarceration. There were even reports that officials intervened to prevent evictees from boarding trains bound for Beijing in order to protest in the capital. Displaced landowners are routinely turned away from the civil courts who plead lack of jurisdiction over an evicting agency's decision. One source reported that less than 4,000 out of 18,000 real estate disputed filed in Beijing were even heard during the first half of 2004. Many evicted homeowners become homeless after receiving minimal or no compensation for their homes. Others are forced to move far outside the cities where their families have lived for generations, not being able to afford new homes in urban areas where property prices are often rising.[104]

[103] [Wang, p607]
[104] [Wang, p610]

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As a result of official channels being blocked, protests have turned extra-legal, and some protests have been deadly and violent. Complaints to government agencies and media outlets have become increasingly important as alternatives to judicial remedies, yet on at least one occasion the national government has attempted to stop the process of petitioning altogether, and has ordered a ban on news reports regarding condemned farmland.[105] As frustrations have risen, more and more notable cases of violence and death have been reported, even in the Western media. For example, the American news source msnbc.com reported that in 2012 three people died in an explosion set off in protest in the demolition bureau in Zhaotong city in Yunnan province. In 2012, in Yangji, a village near Guangzhou, a woman jumped to her death from a building, apparently in despair at the demolition of her house. Two people were killed in Fuzhou in 2011by a suicide bomber who had lost two homes, one in 1995, and one in 2001, to make way for the same highway. In September 2010, three people set themselves on fire in Fuzhou over a land dispute, and one of them died.[106] One writer summarized the situation by saying "By clinging to the political rhetoric of demolition and renewal in the 'public interest,' thereby paving the way for corrupt government officials and land-hungry developers to render thousands homeless and landless, China's government continues to operate urban renewal as a 'top-down' process. The result has been a

[105] [Phan or Wang, I'm not sure which, p634]
[106] "Two women kill themselves, 2 others die over threat to homes in China," msnbc.com, http://worldnews.msnbc.msn.com/_news/2012/05/10/11636799-two-women-kill-themselves-2-others-die-over-threat-to-homes-in-china?lite, accessed on June 6, 2012.

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wave of mass riots and social unrest that have at their root dissatisfaction with the very process."[107]

B. Legal Provisions

1. Background

Given the grave situation in China today, it is surprising to learn that the Chinese government has been taking steps towards reform, including movements towards a more definitive rule of law.[108] These movements towards protection of aggrieved *dingzihu* can be seen as the culmination of an historical process which has moved away from radical Maoism towards and increasing recognition of individual property rights. By the late 1950s, the Chinese government had rendered private ownership of land in cities extremely weak. The rights of Chinese citizens to private property were attenuated further during the Maoist era of "constant revolution." The situation was worsened during the chaotic period of the Cultural Revolution, during which the rule of law, necessary for the maintenance of private property rights, disappeared from China. The excesses of that period created a backlash, which has impelled the government to move further and further towards the protection of private property. The Opening and Reform period, beginning in 1978 under the direction of Deng Xiao Ping, saw the concept of individual property rights regain some definition, both legally and in practice. Deng declared

[107] [Phan, p610]
[108] [Wang, p601]

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that individual urban residents could buy and sell homes. A notion was developed of a "bundle" of property rights that a private citizen could hold. Although the protection of private property rights was granted in order to lure international investors into the country, a side effect was that property rights for individual citizens were strengthened.[109]

Below we shall examine constitutional, legislative, regulatory, and administrative provisions that are relevant to the current Chinese *dingzihu* problem. We shall discover that although there has been movement towards a property regime solicitous of individual property rights, there is still a very long way to go before China achieves security in property for it citizens.

2. Constitutional Provisions

It is important to remember that the Chinese Constitution is subject to change at any time by the Communist Party. Therefore, it is not a constitution as the term is understood in the West; rather, it is more akin to a statement of policy.[110]
The Constitution of 1982 does not entitle individuals to own land; rather, the State owns all urban land and agricultural collectives own all rural land.[111] The socialist philosophy of the Communist Party was explicitly stated in the Constitution of 1982, which stated: "the basis of the socialist economic system of the Peoples Republic of China is socialist public ownership of the means of production,

[109] [Wang, p603-604]
[110] []
[111] [Liu, p313]

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namely, ownership by the whole people and collective ownership by the working people." In 1988, amendments to the Constitution formally recognized the private sector as a "complement" to the "socialist public economy." Other amendments stated that during the primary stage of socialism, "individual, private and other non-public economies are major components of the socialist market economy." The 1988 Constitution, as amended, thus formally recognized the existence of private property in China. The Constitution was further amended in 1999 in such a way that any form of ownership that improved productivity and improved people's lives was seen as serving socialism. In the 2004 Constitutional Amendments, "individual private property was sanctified to the same inviolable level as public property."[112] The 2004 Constitution, as amended, states, ""the lawful private property of citizens may not be encroached upon. By law, the state protects citizens' rights to own private property and the rights to inherit private property."[113] Thus we see quite a remarkable movement towards a recognition of property rights by a formerly Maoist state.

There is a provision in the 2004 Constitution which is of relevance to eminent domain in China. Article Ten of that Constitution states that "[t]he state may, as needed in the *public interest*, take over or use citizens' private property in accordance with the law, and give *compensation*." (emphasis ours) Of note are the changes which have been made to this Article. Article Ten in the Constitutions previous to the 2004 Constitution stated simply, "the State may, in the public

[112] [I don't know where I got this – it's on p64] See [****] for a summary of the changing treatment of private property as the Constitution has developed.
[113] [I lost the cite -its n71]

interest, requisition land for its use in accordance with the law." There was no mention of compensation. Although the 2004 Amendments give citizens a new right to compensation, there was no mention of *just* compensation, as is written in the Fifth Amendment to the United States Constitution.[114] Note also the term "public interest," which is very near to the broad interpretation of the "public use" clause of the Fifth Amendment to the United States Constitution.

Despite the formal grant of private property rights to its citizens by the Chinese Constitution, the laws, regulations, and administrative procedures of the various levels of the Chinese government have extensively favored private developers, who continue to carry out land seizures in the "public interest" in such a way that private property rights of Chinese citizens are egregiously offended.[115]

2. Legislative, Regulatory, and Administrative Provisions

The Land Management Law of 1986 recognized domestic property rights by declaring that the *right to use* state land could be allocated by law. Thus, although an individual cannot have a fee simple interest in land, he does have usufruct rights which he can sell. [116] The Chinese central government enacting regulations in May 1990 ("The Provisional Regulations on the Grant and Transfer of Use Rights in Urban Land") which provided that urban land could be leased from the state for up

[114] [Deng, p4]
[115] [Wang, p607]
[116] [Wang, p605]

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to seventy years, and subsequently could be freely transferred.[117] The government thus in effect created leasehold property interests in urban Chinese citizens.
A watershed law was passed in April 2007, effective October 2007, entitled the Property Rights Law. This important law as passed by the National People's Congress after nearly fourteen years of debate and deliberation. The law is considered groundbreaking, because its passage marks the first time that China has granted legal protection to private property interests in long-term leases of land. Article 4 grants equal legal status for property rights of the "State, collective, *individual*, or any other right holder." (emphasis ours). Article 66 states that "an *individual's* legal properties shall be protected by law, any entity or individual may not encroach, plunder or destroy them." (emphasis ours) Article 66 is often used by property owners facing eviction from their homes or businesses.[118] Article 42 states that private property may be expropriated in the "public interest."The scope of the term "public interest" was not defined.[119] Without a clear definition of public interest, the law left the State with essentially "unrestricted power" to expropriate property.[120]

On December 7, 2009, about two years after passage of the 2007 Property Rights Law, five professors from Beijing University publicly demanded that the government consider reforming land expropriation regulations then in effect. The professors were reacting to events which occurred in Chengdu the month before. A

[117] [Deng, pp1-2]
[118] [Deng –n81]
[119] [Deng, p9]
[120] Rosata-Stevens, p131]

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woman facing the loss of her house and business, which had been expropriated to make way for a road, fought with her siblings against demolition workers (not government workers). As her siblings were being brutally beaten by the demolition workers, she doused herself with gasoline. When the beatings did not stop, she burned herself up in protest, dying sixteen days later. The professors claimed that the Property Rights Law required the *government* to carry out eviction activities, not private parties acting as agents of the developer. As a result of the public letter written by the professors, on January 21, 2011, the State Council announced its approval of a new set of regulations, repealing the regulations which had been in effect since June 13, 2001.[121] These regulations are entitled "Regulations on the Expropriation of Houses on State-owned Land and Compensation Therefore" (hereinafter, "2011 Regulations").

The 2011 Regulations are notable in that they contain the word "Compensation" in the title. "*Fair* compensation" is promised in Article 2. Fair compensation is quite like the "just" compensation mentioned in the Fifth Amendment of the United States Constitution. This is the first time in Chinese law that *fair* or just compensation has been promised to expropriated landowners. The Regulations in Article 3 call for procedural transparency and "democracy." Article 5 gives the relevant local government organ the right to authorize lower level government units ("danwei") to carry out evictions. Nothing is said about the right of the danwei or other government department's right to delegate the task to private

[121] [Deng, pp1-2]

developers, or their agents. Article 8 elucidates for what reasons an expropriation can be made, namely, for "national security," "national defense and foreign affairs," to "promote economic and social development and for other public interests." Article 8 thus tracks very closely current American eminent domain law, which allows takings for "public use," with "public use" being defined very broadly as "public interest." Article 8, however, goes on affirmatively to list many purposes for which a homeowner could lose his home to the state, which effectively precludes courts from forcing a restrictive view of takings on local governments. In the list of public interests which will justify a taking are "needs of science and technology, education, culture, health, sports, environmental and resource protection, disaster prevention and mitigation, heritage conservation, social welfare, municipal utilities and other public utility projects." Also listed are "construction projects for affordable residential houses," and "old city reconstruction projects for districts where dilapidated buildings are concentrated and poor infrastructure facilities are located."

The 2011 Regulations go on to say, in Article 17, that compensation should not only include the value of the expropriated houses, but also compensation for relocation and temporary resettlement, as well as losses arising from the interruption of any business. Article 27 states that "compensation shall be paid first before relocation." Nothing is said about what should occur should appeals over the compensation amount take longer than the time at which demolition should occur.

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Violent eviction procedures that have caused so much unrest are deal with in Article 27, which states, "No unit or individual may compel the persons whose houses are expropriated to relocate through violence, threat or other illegal methods such as water, heat, gas, power supply and road access suspension in violation of the regulations. Construction units shall be prohibited from participating in relocation activities." Although this regulation prevents construction workers from forcing owners from their homes, which has been a large concern, this Article says nothing about whether other private agents hired by a developer can carry out an eviction. Anyone who uses one of the illegal methods above to evict a homeowner is subject to criminal prosecution (Article 31). Likewise, anyone impeding a house expropriation through violence and illegal means, is also subject to criminal prosecution (Article 32).

Two matters that have caused a lot of unrest were not completely dealt with by the regulations. The first is the matter that the Beijing professors complained about in 2009, namely, private parties performing the evictions. The 2011 Regulations prohibit contractors specifically from performing such actions, but there is no mention of a prohibition on other private parties carrying out the evictions. There are other regulations and laws that are relevant to the Chinese takings process. Their complex interactions, plus the complicated hierarchy of Chinese law (fundamental law, basic law, and specifically enacted law), plus the fact that the laws and regulations were passed at different times by different bodies, and plus the fact that the promulgating body cannot be discerned by looking at the title of

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the law, but must be discovered by looking at the enactment history of the regulation – all these factors make the law very compex, opaque, and difficult to enforce.[122] This, coupled with local officials' bias toward developers, whose development projects can advance the political career of local officials who are judged upon how much they develop their cities, has led to a situation where condemned property owners often feel aggrieved. Constitutional provisions and property codes are much easier to enact than to enforce, because informal rules of procedure are far beyond lawmakers' control.[123]

3. Procedural Matters

Before the promulgation of the 2011 Regulations, there have been many procedural abuses that have offended property owners. One is "advance enforcement." The old 2001 Regulations stated that once a demolition has been approved, the private developer, or the state, negotiates compensation with the property owner. There is specified a time period, during which the homeowner must move out, *whether or not negotiations for compensation are finished or not*. This caused many people to stay in their homes past the time they were supposed to leave, because they were negotiating compensation, and this caused many forced evictions.[124] This forced deadline is not suspended even by a property owner's appeal to a people's court.[125] The 2011 Regulations have attempted to ameliorate

[122] [Rosato-stevens 103-104]
[123] []
[124] [Wang, p608]
[125] [Chen, p114]

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these conditions to some degree. They state that if the developer and landowner cannot agree on a compensation amount, no demolition may occur without a court order to demolish. This remedy, to be effective, must assume that a court is neutral enough not to just willy-nilly grant a court order to the developer.126

Another judicial remedy ostensible available to aggrieved property owners is appeal from the boards and agencies of the local government to the judicial system. However, judicial remedies have been limited, because the People's Courts have only allowed appeals after all procedural remedies have been exhausted. This effectively has denied judicial recourse, because most complaints and negotiations have been usually stifled at the administrative level, usually leaving the property owner with "massive disappointment."[127] The 2011 Regulation seeks to remedy this. In the past, administrative review had to be exhausted before a landowner could appeal to the courts,[128] and often when the appeal went to court, the court would dismiss the claim by saying the issue was moot, because the property had already been destroyed.[129] The new laws and regulations relevant to this issue now provide that an aggrieved landowner can appeal directly to the courts, without having to invoke administrative review at all.

[126] [Deng, p14]
[127] [Chen, p114]
[128] [Rosato-Stevens, p139]
[129] []

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C. Comparison with American Eminent Domain Law

Just as Chinese condemned property owners feel aggrieved, so do American property owners in the same situation. The discussion in this paper in Section IV, Part D ("Takings for Economic Development") could apply very well to Chinese property owners.

There are other comparisons (as well as contrasts) between the American and Chinese law on takings. Interestingly, Chinese scholars have taken note of the *Kelo* case, and have compared it to the situation in China. The Chinese government, through the government-controlled press, made know the decision in the *Kelo* case. According to one scholar, the motive behind this was obvious: it implied that the United States was no better than China in protecting private property, and that condemnations for economic development, if justified in the United States, were also justified in China.[130] If this was the Chinese government's implied argument, it is a good one in many aspects. The fact situations and the law are remarkably similar. One scholar has said that comparisons between the two countries' takings laws are not valid, because in *Kelo*, the court deferred to the local governments (just like the Chinese central government does), but in America, local governments are democratic, and are thus subject to popular pressure which will protect property owners. In China, argues this writer, the local governments are quite undemocratic and quite unresponsive to local pressures, and so there is more injustice to the

[130] [Liu, pp332-333]

property owner in China. In the authors' view, this argument fails because, as a matter of fact, democratic procedures do *not* work at the local level in America to protect property owners, for reasons we have already outlined in the section above entitled "Developers Can Be Restrained by Political Action," where we argue that political action does not, indeed, work to protect condemned property owners. However, it must be granted that state legislatures have operated in a limited fashion to protect individual property owners (see above, "III. F. The *Kelo* Backlash"). It would be difficult to argue that China provides, at the local level, a level of protection to the individual property owner that might match even the limited protection that the American local governments provide.

It is the authors' contention that, with regard to what property may be condemned, American Supreme Court law and Chinese takings law is essentially the same, any difference existing being differences of degree, not differences of kind. First, the "public use" definition in American law, and "public interest" definition in Chinese law, is essentially the same. Because the definition of "public interest" in Chinese takings law is so broad, there is no legal remedy for a landowner facing condemnation, and who wants to stop it.[131] Were it not for state laws narrowing the U.S. Supreme Court's definition of "public use," the situation for property owners in America would be exactly the same.

[131] [Liu, p318]

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With regard to compensation for expropriated property, the American law and Chinese law is quite similar. The Fifth Amendment of the United States Constitution states that owners of taken property must be given "just" compensation, and the 2011 Regulations also require "just" compensation in China. Before the 2011 Regulations, there has been movement in China towards requiring a more just compensation. The 2007 Property Law provides in Article 42 that is is necessary to make compensation for demolished property and for relocation, and that the legitimate rights and interests of the owners of condemned property owners should be safeguarded.[132] However, the 2011 Regulations not only call for "just" compensations, they also call for compensation for relocation and temporary resettlement, and compensation for losses arising the the interruption of business.

On a more philosophical level, it is remarkable that in both countries the ideological justification for takings for economic development is quite similar. The American courts, having moved away from the Lockean foundations of the United States Constitution, more and more moved to a pragmatic justification of takings: such condemnations boosted the economy. This, of course, is exactly the same position of the Chinese government today.

It is interesting to note a certain convergence of philosophy between the two countries. America began from a philosophical foundation of individual natural

[132] [Chen, p113]

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right to property, and moved from there to a more pragmatic, collectivist view that obligates individuals to subordinate their individual right to the rights of the collective. As one commentator put it, American judicial decisions did not "reason upward from private rights and particular injuries…instead they reasoned downward from autonomous conceptions of state powers, public rights, and the general welfare of the society," thus proceeding, in an instrumentalist fashion, to the advancement of wide police powers in a strongly-regulated United States.[133] On the other hand, China has started from a collectivist view that gave no scope at all to individual property rights, but since has moved more and more, because of pragmatic pressures, to grant individuals property rights. Neither country has entirely abandoned its philosophical roots. However, both countries now may be said to be operating pragmatically, with no jurisprudential anchor to guide law or policy.

VI. Policy Options for China

A. Change the Substantive Law

China could solve its *dingzihu* problem by simply redefining "public interest," so that takings in the "public interest" would exclude takings for economic development. This would leave as the only legitimate takings those carried out for

[133] [Wang, p614, quoting William J. Novak]

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"public use" functions (narrowly defined), such as for roads, dams, military installations, and also takings to rid a city of "blight." The advantages and disadvantages of outlawing takings for economic development in America, discussed in Section IV above, "From Narrow to Broad: Four Possible Positions on Takings," should apply with equal force to China. One commentator has noted that "it is possible for China's lawmakers to sufficiently define the public interest to prohibit the taking of… land for solely commercial purposes."[134] Legal commentator Wang Quandi opined that while it might not be the best thing to define "public interest" substantively, it would, however, be possible to restrict the breadth of definition that public authorities put on the term.[135] It should be noted that several American states, in the aftermath of *Kelo*, did exactly that.[136]

B. Change Condemnation Procedures

Given political realities in China, where many of the leading members of the National People's Congress are wealthy developers, it may prove quite difficult for China to fundamentally change its substantive law of takings. The authors believe that this is the best solution. However, more moderate approaches should also prove beneficial. It is not difficult to conceive that reform of condemnation *procedures* (as opposed to substantive law) might be effected so as to eliminate the most egregious injustices taking place. This might help restore social harmony. To set up this discussion, we will first describe China's current takings procedures

[134] [Rosato-Stevens, p132]
[135] [quoted in Chen, p115]
[136] [Wang, p600 – or is it pp 15-17?]

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with a view to highlighting certain troublesome aspects. Afterwards, we will suggest certain procedural reforms.

1. Problems with China's Takings Procedure

All procedural reforms undertaken by China so far, including the 2011 Regulations, are subject to the criticism that these reforms are merely on paper, but do not impact the real life of Chinese citizens threatened with the expropriation of their property. Certain realities in China often obstruct the smooth functioning of legal and administrative processes which might provide relief, if Chinese laws and regulations were implemented completely and uniformly. For example, rural landowners facing eviction have insecure, non-marketable land rights , and they have no access to information about land values, which attenuates severely their negotiation power. Second, few farmers are actually consulted about compensation, although consultations are legally required. Third, few farmers actually know what their rights are under the law. Fourth, the same town governments that are responsible for the decision to expropriate are also involved in the determination of appropriate compensation. Thus, the very tribunal that caused the landowner to lose his property then decides how much to compensate. The agency that decides an individual's property is worth less than a developer values it is not likely going to give an impartial decision to an expropriated landowner. Fifth, a farmer seeking administrative review is often met with repeated

responses to submit another letter to another official, thus drowning the property owner in a bureaucratic quagmire, forcing many just to give up.[137]

Because of the difficulty of obtaining administrative relief in the past, the 2002 Rural Land Contracting Law, and the 2011 Regulation provide for appeals to the judicial system. In the past, administrative review had to be exhausted before a landowner could appeal to the courts,[138] and often when the appeal went to court, the court would dismiss the claim by saying the issue was moot, because the property had already been destroyed.[139] The new laws and regulations relevant to this issue now provide that an aggrieved landowner can appeal directly to the courts, without having to invoke administrative review at all. On the surface, this would seem to be a powerful weapon in the hands of a landowner facing eviction. However, there are practical realities that blunt this weapon. First, oftentimes rural landowners do not even know they have the right of appeal, and second, they often do not have the means to sue. Another very difficult problem is that court's are often not impartial, the judges being subject to corruption. In addition, the judges are appointed, promoted, and removed by local government and Party leaders, the same leaders who are the ones who are often in bed with developers.[140] The judges are even funded by local government leaders, which also tends to create a general reluctance for Chinese courts to give relief to property owners. As a result of these

[137] [Rosato-Stevens, p136-138]
[138] [Rosato-Stevens, p139]
[139] []
[140] [Rosato-Stevens, p139]

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pressures, the Chinese judiciary as of 2007 had not once recognized an evicted property owners claim based on constitutionally based rights."[141]

2. Suggested Procedural Reforms

Despite the difficulty in actually implementing helpful reforms, and in the light of the difficulty of changing the Chinese substantive law of takings, any procedural reform is better than no reform at all. Below are some suggestions.

Adopt a "Givings" Approach. The basic idea is that all property owners in a district marked for condemnation would be allowed to vote on whether they want the condemnation to proceed.[142] Thus the name, "givings." The emphasis is on the property owners voluntarily giving the property to their city (and the developers), rather than having the land torn from them. The city of Qingdao, in Shandong province implemented this approach when it required developers to reach agreement with at least 95 percent of affected residents before the development was allowed to proceed.[143]

Increase Compensation Until it's "Just". The central government in China has repeatedly issued notices or regulations demanding that local governments increase compensation to displaced property owners, for example, the 2003 Guiding Opinions on the Appraisal of Urban Housing Demolitions issued by the Ministry

[141] [Chen, p 115]
[142] [Chen, pp 110-111]
[143] [Phan, p650]

of Construction, which requires that compensation be based on market value. However, because the real estate market is so undeveloped, it has often been difficult for landowners to ascertain fair market value. Local governments have set a low compensation value, and it has been difficult for landowners to argue that the proposed compensation was below market value. In addition, developers were legally required to set aside funds for compensation, but very few did so, because of the lack of an enforcement mechanism.[144] Undercompensation was severe. Compensation was calculated based on the actual value of the house without including the value of the underlying land, which was often higher than the value of the house.[145] If it was farmland that was being condemned, it has been difficult in valuing land that farmers have not right to sell (because of special laws that differentiate rural from urban land).[146]

Chronic undercompensation has led to the *dingzihu* phenomenon. Acquisition authorities have the necessary administrative power and media control to compel evictions which are not only unjustly compensated, but completely uncompensated. Certain landowners who are clever and brave, and who perceive themselves as having nothing to lose, then make a last stand on their property, embarrassing the local authorities through the use of local, national, and even international media. The local government then is forced to pay exorbitant amounts

[144] [Liu, pp322-323]
[145] [Chen,p116]
[146] [Rosato-Stevens, p136]

to avoid the embarrassment. Thus, for some condemned landowners, there is unjust compensation, whereas for others, there is overcompensation.[147]

The 2001 Regulations mention compensation only in passing, and no substantive guidelines are given in regard to its calculation. However, the new 2011 Regulations state that compensation must be market value on the date of requisition of the land. Relocation expenses must be paid, as must losses for business interruption. Neutral, third-party appraisers are required, to avoid undue influence from local governments and developers. However, the Rural and Urban Development Division of the State Council is given the responsibility for passing rules the appraisal companies must follow. It is an open question whether these rules will be written in such a manner as to provide fair appraisals.[148]

Without question, the 2011 Regulations have improved the chances for the expropriated property owner to receive just compensation. However, even with a perfect procedure, as a matter of economics, the condemnation process itself works to avoid the determination of a just compensation price, for reasons detailed above, in the section entitled "Owners of Condemned Land are Undercompensated."

Reform the Political System by Increasing Democracy and Reducing Corruption. The Chinese political system hinders the production of procedural reform at the administrative level. Even if new regulations are crafted that create needed

[147] [Chen, p117]
[148] [Deng, p15]

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procedural reform, without changing the system within which the regulations are created, there will be no effective relief for displaced property owners. There are several major problems with this system. The first is that the political system does not represent expropriated property owners. The process of drafting and passing regulations and laws in China is undemocratic, and not transparent. The people whose lives are being affected the most, expropriated property owners, have very little input into the system that produces the laws and regulations that affect their lives. The decision to requisition and evict is rarely subject either to public scrutiny or participation. Before they have had an opportunity to voice their displeasure, homeowners and business owners have often already lost their homes and livelihood. [149] Lacking input, powerless citizens have taken to the streets to protest, resulting in social unrest and embarrassing publicity in the foreign press. The second problem occurs because, even if perfect regulations are produced by the central government, there is a decided lack of oversight by the central government over local government, in order to assure that regulations are enforced properly. The government in Beijing does not have the resources to properly oversee every takings case in the country. The third problem is the existent of widespread and institutionalized corruption in the country. If corrupt developers grease the palms of corrupt local government officials, no condemned property owner can expect to receive just treatment by the system that took his house or business away.[150]

[149] [Phan, p631]
[150] [Deng, pp3,13]

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Of course, creating democracy, and ending corruption in China at this stage of history might seem utopian. In addition, creating democracy and ending corruption specifically in the area of takings is even more problematical, because of the complex nature of the takings process, which makes it difficult for intelligent voting, and because the affected landowners are relatively few compared to the voting population. In fact, China's National Land Vice-Commissioner has said that corruption relating to land acquisition is currently China's most prominent corruption problem. The efforts of top level officials to hinder rampant corruption below them often have little effect.[151] The problems in establishing democracy and ending corruption in the Chinese condemnation process would most certainly track the same problems that occur in America, as described in the section above entitled "Local Governments Become Captive to Special Private Interests."

Reduce the Power of Local Officials and Developers. Chinese central government policies have encouraged the devolution of power toward local municipal officials. The performance of local officials is not judged by voters; rather, by measures of quantitative growth which are reported upward to the central government. As a result, (in 2009) about 50 percent of local government revenues came from sales of land use rights to developers throughout China. Lacking in oversight from above, immune from any voter pressure, city officials quite naturally enter into alliances with developers. Given this fundamental reality, it is unrealistic to expect any reforms to have more than a marginal effect on the takings predicament in China.

[151] [Chen, p118]

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As one writer put it, "If the New [2011]Regulations are revised to contain more detailed expropriation, demolition, and compensation procedures and narrower definitions of public use, then the Chinese public might be able to experience an incremental increase in the fairness of land expropriations. However, no matter what changes in wording are made, because no effective checks on corrupt local government powers currently exist, enforcement problems will remain and the takings problem will not be solved."[152] With respect to the specific procedures of eminent domain, more democracy is not likely to effectively check local officials, as some suggest.[153] However, it could not hurt the current situation. In addition, if the central government would cease to give political rewards for fast economic growth, local officials would much less likely ally themselves with developers to the detriment of property holders.

Reform the Judiciary. There are many problems in the Chinese judiciary. The judiciary is not independent, but is dependent on the government to fund it. The judges do not have the power to interpret or review any laws or regulations. There is no concept of separation of powers: the judiciary, administrators, law enforcers, legislators, and judges all answer directly to the Communist Party. Therefore, if local Party officials and administrators favor developers, it is difficult to conceive local judges taking an independent direction.[154] How to reform the judicial system

[152] [Deng, p16]
[153] [Deng, p16 suggests more democracy as a remedy. But see our discussion under "Local Governments Become Captive to Special Private Interests," p **, for arguments *contra*.
[154] [Deng, p4]

in order to ameliorate these problems is easy to conceive, but obviously, quite difficult to implement.

Reform Demolition and Relocation Procedures. A major grievance suffered by condemned property owners was brought about under the 2001 Regulations, which allowed demolition to occur before the property owner could finish negotiating a just compensation.[155] If the compensation award was appealed through the courts, the landowner's property would often be demolished, and under these circumstances the 2001 Regulations stated that "once the basis of the dispute has been removed, the homeowner can no longer appeal." Since the homeowner's property under these circumstances had been demolished, the homeowner no longer had standing in the courts.[156]

Another problem brought on by the 2001 Regulations was that Article 17 for all practical purposes legitimized the use of coercion and violence against those who resisted eviction.[157]

The 2011 Regulations have attempted to ameliorate these conditions to some degree. They state that if the developer and landowner cannot agree on a compensation amount, no demolition may occur without a court order to demolish.

[155] [Deng, p9]
[156] [Deng, p9]
[157] [Deng, p9]

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This remedy, to be effective, must assume that a court is neutral enough not to just willy-nilly grant a court order to the developer.[158]

The 2011 Regulations also attempt to deal with the infamous violent and coercive evictions that have plagued China in recent years. First, the power to demolish is taken out of the hands of private parties and placed directly within the government's responsibility, thus limiting the power of private demolition crews from terrorizing residents. Secondly, the 2011 Regulations specifically state that no coercive or violent means may be used to evict expropriated property owners.[159]

C. Change Judicial Philosophy

It is clear from the above discussion concerning procedural reforms, that procedural reforms do not hold out great hope to solve the *dingzihu* problem. These reforms need to be systemic; however, piecemeal reforms are likely to be subverted by other non-reformed components of the administrative and judicial system. Powerful political and ideological interests impede would-be reformers, as does human inertia. In addition, certain features endemic to the takings process itself makes reforms particular to eminent domain difficult to effect. Given these realities, it would seem to be easier just to change the substantive law, as discussed above, and narrowly define "pubic use" in such a way that individual property

[158] [Deng, p14]
[159] [Deng, pp13,14]

owners would be protected from rapacious developers. However, the same political and ideological interests resistive to reform of course, would, resist such a redefinition of the substantive law of eminent domain. What is needed is a revolution in judicial and political philosophy – a recognition of property rights as a natural, God-given right of the individual, not to be violated by positive law, and protected by the state and the courts. This suggestion will seem quite radical, given the communist roots of modern Chinese society. It is even radical in the context of modern American society; however, there are large potential paybacks should such a philosophy be adopted in modern Chinese culture.

China has many incentives to reform. First, it is hard to imagine China achieving its oft-stated goal of a "harmonious society" given the current situation. And ironically, the loss of a harmonious society will jeopardize the very goals that the current takings regime seeks to advance. Social chaos has never led to prosperity, as China has well-learned during the Taiping rebellion in the nineteenth century, and during the Cultural Revolution in the twentieth.[160]

Second, China's reputation is suffering internationally. In 2001, China ratified (among other international agreements) the United Nations International Covenant on Economic, Social and Cultural Rights (ICESCR). This document stipulated that forced evictions were prima facie incompatible with the document's purpose. China gained worldwide respect and legitimacy by ratifying this agreement.

[160] [Long, p68]

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However, in 2005, the United Nations Committee on Economic, Social and Cultural Rights held hearings which reflected negatively on China, filing numerous complaints and objections. Since then, China has responded to the *dingzihu* protests with incarceration, suppression, disregard of petitions, disregard of international calls for reform.[161] It remains to be seen whether the 2011 Regulations will alleviate some of this negative international pushback against China.

Third, China is hurting itself economically. A farmer who comes home to find that his land is being chewed up by a developer's bulldozer, or a farmer who is worried that this might happen, is not going to be very likely to invest in capital improvements of his land. People with insecure property rights do not focus their energies on producing wealth, they expend their resources on fighting to keep what they have.[162]

Therefore, although a property-rights reformation would seem unlikely to spring from the soil of a communist nation, pragmatic realities such as the three just listed provide pressure not just for marginal legal and procedural reform, but deep-rooted cultural and philosophical reform.

[161] [Wang, p625]
[162] [Long, p63]

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VII. Conclusion: A Call for Reform in both america and china

Deviating from the natural rights foundation upon which the United States Constitution was built, American eminent domain constitutional law has progressively moved towards a collectivist vision in which the needs of "society" dominate the rights of individuals. Despite judicial restrictions upon legislative infringement of individual liberties in other areas, for example, racial civil rights, the court has given a free reign to state legislatures and the private special interests which dominate those legislatures to deprive American citizens of their individual natural rights. As a result, injustices have become palpable, and a backlash upon the part of aggrieved citizens has made a powerful, if incomplete, impression on the legal system in America. A return to the strict definition of "public use," as advocated by Justice Clarence Thomas in the *Kelo* case would alleviate much, if not all, of the injustice. Granted that such a sea change in current law is unlikely to be effected, even a ban on takings for economic development would effect a huge improvement in the current practice of eminent domain, even if takings for blight were still allowed.

Can the American experience provide light to other countries, such as China, who are experiencing the same social phenomena as the United States, as countries race to develop their urban areas? In the case of China, we think the answer is yes, in

spite of the different constitutional, philosophical, and historical foundations upon which the two countries have been built.

For one thing, America can provide a negative example. The outcry and the backlash against takings for economic development after *Kelo* can be used by the Chinese to see what happens when a country deviates far from a natural rights philosophy. In addition, the different approaches by the state legislatures can be used as laboratory experiments to observe how protecting natural property rights leads to social harmony.

There are many who believe a fundamental philosophical transformation is impossible in China. One writer has stated that "[W]hile it is easy to encourage China to take the same course America did in granting absolute protection of individual property rights, the characteristics of the two countries differ to the extent that this wholesale adoption would be unreasonable"[163]

Another commentator opines, "that the current objections against economic development eminent domain are unlikely to be based on some sacred notion of absolute property rights. Indeed, the main objections to economic development eminent domain are the injustice and inefficiency arising from rent¬seeking and undercompensation."164 These sentiments are certainly understandable. However, against the backdrop of the revolutionary changes in philosophy China has

[163] [Wang, p601]
[164] [Chen, p157]

undergone since 1978, the possibility of China granting absolute protection of individual property rights might not seem so "unreasonable". Consider the changes since 1978. During the Maoist regime from 1949 to 1976, the Communist Party regularly confiscated private property for "national construction." However, in 2004 the Chinese government passed amendments to the Constitution guaranteeing property rights, a "revolutionary" development.[165] Recent Chinese constitutional and legislative texts, books, official propaganda, and articles affirm essential principles of Western liberalism, including language about human rights, the state as a social contract, the authority and legitimacy of government is derived from the consent of the governed, government power needs to be limited by law to protect individual rights. Theoretically, at least, China seems to be moving towards the Western concept of safeguarding life, liberty, and property, with influential legal scholars insisting on the significance of all three.[166]

Therefore, is it utopian to call for a political and legal regime in China that protects an individual's property rights, not pragmatically because it fosters economic development, but as a matter of simple justice? Is it a fantasy that China might restrict economic development takings, or even takings for blight, and return to a "narrow" interpretation of "pubic benefit"? We don't think so. And we also believe that pragmatically, soothing results will follow our suggestion: China will enjoy a harmonious society. China will win the applause of the world community. And finally, China will quit hurting itself economically. Then, perhaps, China's

[165] [Wang, p603]
[166] [Phan, p637]

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example can help lead America back to its roots, when property rights were sacred, and not something to be cruelly sacrificed on the high altar of "economic development." Perhaps then both China and America can show the world what it means to be just, rather than merely wealthy.

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Footnotes:

1 In 1996 Thailand's stock exchange dropped from 1364 to 787 points, then in 1997 it dropped from 787 to 207 points (Chan & Liu, 2002).
2 Consortium groups regulating oil markets include the Texas Railroad Commission (TRC) from the late 1800's through to 1973 then the Organisation of Petroleum Exporting Countries (OPEC) from 1973 onward.
3 Mintzberg (1994, p. 107) describes soft data as "soft insights from his or her personal experiences and the experiences of others throughout the organization"
4 Pierre Wack was head of the business environment division of the Royal Dutch/Shell Group planning department from 1971-81, then went on to become a senior lecturer at Harvard Business School. Royal Dutch/Shell Group set the gold standard for scenario planning during the oil crisis of the 1970's (Burt, 2010; Jefferson, 2012).
5 Correct and full titles are; Strategic Management Tool Usage: A Comparative Study (D. N. Clark, 1997) and The Use of Strategic Tools by Small and Medium-sized Enterprises: An Australasian Study (Frost, 2003)
6 Clark (1997) proposes the following phases; situational assessment, strategic analysis and implementation. Frost (2003) proposes the following stages; current direction, strategic audit, environmental analysis, macro analysis, strategic analysis and implementation.
7 SWOT: Strength, Weakness, Opportunities and Threats analysis.
8 PEST: Political, Economic, Social and Technological (often added to with Environmental, Legal, Globalisation and Megatrends) trend analysis.
9 Porters-5-Forces describe power of an organisation relative to that of customers, competitors, suppliers, new entrants or substitutions.
10 Transcription completed by TranscribeMe (http://www.transcribeme.com).

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Governance for Small to Medium Enterprises in New Zealand

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Abstract

There has been little empirical research relating to how governance practices impact Small to Medium Enterprises (SMEs) in New Zealand (NZ), even though SMEs have an influential role in the NZ economy. Our research investigates SMEs, to determine whether there might be value for them in adopting good governance practices and whether there are barriers preventing them from doing so. We examine the possibility of creating a good governance framework for SMEs, rather than having them try to adopt established frameworks developed for listed companies.

Introduction

This research identifies the benefits SME owners may gain from adopting good governance practices. Good governance may help owners improve the strategic development of their businesses, and make it easier for them to monitor and manage risks. This could lead to significant benefits in the NZ economy (e.g. higher tax revenues and employment rates).

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Literature Review

There is no consensus definition of SMEs (Abor and Adjasi, 2007). SMEs adopt many forms and corporate structure is just one of them (Hewa-Wellalage and Locke, 2011). Our research found that family-based SMEs represent one of the most common types of SMEs worldwide (Casillas, Acedo and Moreno, 2007). These SMEs often develop a dual governance structure to satisfy both their economic and non-economic goals (Mustakallio, Autio and Zahra, 2002). This suggests a need to develop a specialized governance framework for SMEs. The Small Business Advisory Group in its 2012 report to the Ministry of Economic Development describes the common characteristics of a NZ SME as:

1. Typically owner operated.
2. Owners are independent, able to make unencumbered decisions.
3. Have fewer than 20 staff members.
4. Have a relatively small market share.

Approximately 30% of the working population of NZ is employed by SMEs. For the year ending March 2010, SMEs contributed $52.8 billion towards the country's GDP (Ministry of Business Innovation and Employment, 2013). However, the survival rate of SMEs is a concern. Graph 1 shows the rate of survival is declining. The rate is worse for smaller businesses. Graph 2 shows that since 2009 there are more SMEs being closed than set-up.

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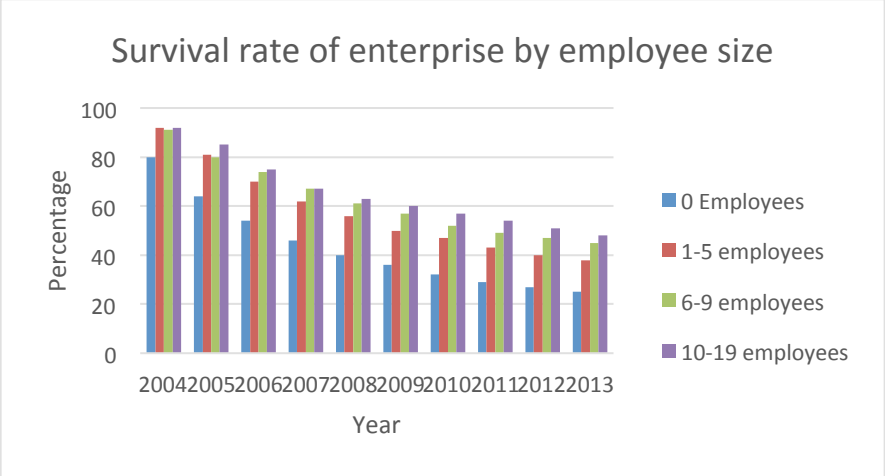
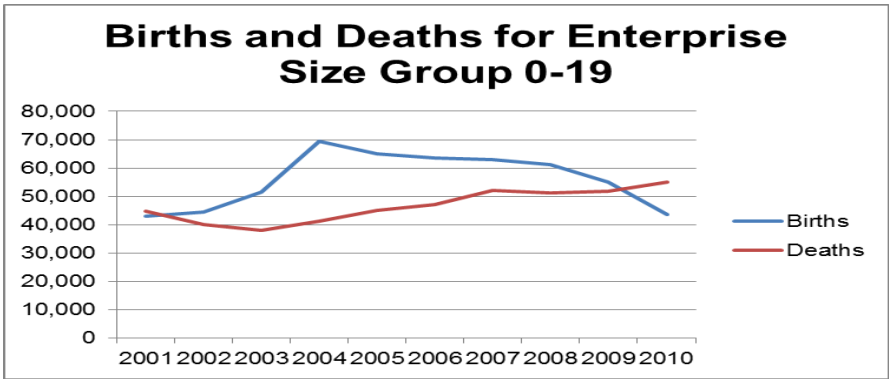
Graph 1: Survival rate of enterprise by employee size



Source: Statistics New Zealand Business Demography at Feb 2013

Graph 2: Birth and Deaths of SMEs



Source: Ministry of Economic Development and Statistics New Zealand (2011).

Definitions of governance generally refer to the processes by which organisations are directed, controlled and held to account. Corporate governance sets the principles for sound business practices which in turn lead to greater accountability, integrity, efficiency, transparency and sustainability. These reinforce stakeholders'

confidence (Mardjono, 2005). The OECD (2004) provides a definition of corporate governance:

A set of relationships between a company's management, its Board, its shareholders and other stakeholders… providing the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined. (p. 11)

Governance has become a major issue due to the global financial crisis and the collapse of prominent companies around the world. Most of the attention however is focused on listed companies (Gabrielsson and Huse, 2004). There has been little empirical work relating to how governance impacts SMEs (Hewa-Wellalage and Locke, 2011). Most research on governance involves larger companies, hence the term "corporate governance" (Moscariello, 2012). This research often adopts an "agency theory" approach and discusses "director independence" and "goal congruence". It does not address many of the problems inherent in SMEs, where the number of players is small and relationships are closer.

There are various opinions as to why corporate governance does not apply to SMEs. Abor & Adjasi (2007) state that because there is often no clear line of distinction between ownership and management in SMEs, corporate governance is not relevant. Clarke and Klettner (2009) question whether there is a need for SMEs to adhere to corporate governance principles as agency gap may not exist

and owners can look after themselves. Some argue that because most SMEs do not depend on public funds there is no accountability issue (Abor and Adjasi, 2007).

However, elements of corporate governance (e.g. having a strategic direction, accountability, transparency, etc.) may be important to SMEs precisely because of the blurred lines between ownership and control. Unfortunately, SMEs often lack the resources to implement proper governance structures (Hewa-Wellalage and Locke, 2011).

It is important to note the difference between governance and good governance. What businesses need is good governance. Just because they have governance systems in place does not exempt them from failure. Unfortunately good governance is often not seen as an important element by SMEs. Horsley and Ahmed (2011) explain that the most crucial requirement for SMEs is profitability; governance and sustainability considerations are given a lower priority. Any linkages between these variables are often being missed.

Wells and Mueller (2012) state that governance can be described as "good" when the policies of governance are implemented and an increase in value results (not necessarily in monetary terms). The benefits must exceed the costs of implementing the governance systems. Governance principles (e.g. systems, policies, accountabilities and long term strategic directions) are not the exclusive domain of listed corporations; they are also helpful to SMEs. Ultimately good

governance is about how to make good decisions where people are a major variable (Moxey and Berendt, 2014).

In NZ, the governance framework revolves around the Corporate Governance Best Practice Code introduced in 2003 by the NZ Stock Exchange for NZ listed companies. Subsequently the Principles on Corporate Governance were introduced in 2004 by the Securities Commission (later revised in 2011). Unfortunately, this current framework is not necessarily relevant to SMEs as it focuses on listed companies.

Various researches have shown that there are benefits associated with implementing good governance practices. Abor and Adjasi (2007) suggest that the benefits of implementing good governance practices are more pronounced in growing companies. SMEs may benefit from obtaining a board's input on management practices, especially in relation to finance (Machold, Huse, Minichilli and Nordqvist, 2011). An active, empowered board can provide SMEs with: assistance on critical strategic issues, identifying new market opportunities and facilitating product development (Gabrielsson, 2007). It may also: identify better funding resources, inspire innovation and creativity, and help create a better work culture (Abor and Adjasi, 2007). SMEs are generally characterized by a lack of internal resources, and a need to compliment the competencies of the owner-manager (Neville, 2011). A board should help ensure that the interests of management do not conflict with the interests of the company (in most SMEs the

owners are both managers and directors). Clarke and Klettner (2009) posit that the greatest benefit for SMEs in implementing corporate governance procedures is the enforcement of discipline on the owners/directors, who are used to doing things their own way.

Our research found some barriers that prevent SMEs from adopting good governance practices with management incompetence being the most glaring one (Abor and Adjasi, 2007). Coleman and Howieson (2007) provide a list of reasons why SMEs are reluctant to adopt a board structure:

1. It would cost time and money;
2. It would create additional work;
3. Fear of being thought naïve or ignorant by the other directors or shareholders.
4. Belief that a bureaucracy will destroy the ability to respond quickly.

Gabrielsson (2007) suggests that having a board of directors may be perceived as more of a hindrance than a benefit. Neville (2001) explains that SME owners wish to retain complete control. Khlif, Ingley and Karoui (2012) suggest that the dominant position of the founder (common with many SMEs) may be a barrier to critical judgment, resulting in weak evaluation of risks, leading to failure and bankruptcy. Clarke and Klettner (2009) report that many SME owners do not wish to introduce convoluted policies because they will drag down productivity. Another barrier is that SME owners often "wear too many hats" or adopt too many

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roles (Rosenberg, 2012). Multiple roles played by a single person, prevent him/her from 'letting go' of the business in order for it to achieve its growth potential. Many SMEs are operated by owners/founders, and most do not encourage active boards for fear that these would limit their independence (Gabrielsson, 2007). The Research Questions which emerged from the literature review are:

1. How much do SME owners tend to know about governance when they first start?
2. What are the potential benefits of SMEs adopting good governance practices?
3. What are the barriers preventing SMEs from adopting good governance practices?

Method

Our research adopts a qualitative approach. This allows the data collection to be fluid. Our primary research tool is semi-structured interviews. We interviewed 25 SME owners in the Waikato region of NZ (see Table 1). The participants were drawn from many industries. The majority of the participants (88%) own active businesses; three participants were interviewed in relation to their past businesses (either sold or wound-up). 68% of the participants have been in business for over 5 years. The three participants no longer in business were in operation for less than 5 years. The types of SME were: companies (88%), sole traders (8%) and partnership (4%). Family based SMEs made up 56% of our sample. To identify

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participants' inputs, participants were identified using sequential numbers (R1 to R25) as seen in Table 1.

Table 1: Participants

	Existing Business		**Length of business**		**Type**		**Family based**		**Nature of Business**
Participant	Yes	No	0-5 years	>5 years	Company	Other	Yes	No	
R1	V			v	V		v		Trellis Mfg
R2	V			v	V		v		Car Auction
R3	V			v	V			v	Furniture Mfg
R4		v	v		V		v		Food
R5	V			v	v		v		Tiling
R6	V			v	v		v		Rental Properties
R7	V			v	v		v		Accommodation
R8	V			v	v		v		Clothing Hire
R9		v	v			v		v	Café
R10	v		v		v		v		Clothing Second hand

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R11	v			v	v		v		Private Training Establishment
R12	v			v	v			v	Private Training Establishment
R13	v			v	v			v	Financial Planner
R14	v			v	v			v	Boat Mfg, Fishing supplies
R15	v			v		v		v	Landscape
R16	v		v		v			v	Properties
R17		v		v		v		v	Fund Management
R18	v		v		v			v	Property Developer
R19	v			v	v			v	Comic Shop
R20	v		v		v			v	Recruitment Agency
R21	v			v	v			v	HR Recruitment & Services

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R22	v		v		v			v	Accounting Firm
R23	V			V	V			v	Eye Surgeon
R24	v			v	v		v		General Practitioner
R25	V			V	V			V	Printing

The interviews were recorded and transcribed. The transcriptions were analysed to reveal various themes. Our research is an exploratory study of a small number of local SMEs. It does not attempt to provide statistically valid generalisations. Rather it gives an insight into the state of governance in a small group of SMEs, and provides support for the conclusions provided in this exploratory study.

Findings

These are presented as responses to each of the three Research Questions (p 4).

Question 1: How much do small business owners tend to know about governance when they first start?

The responses are divided into "Prior Knowledge" (i.e. what they knew prior to setting up the business) and "Early Learning" (i.e. what they learned subsequently). In terms of "Prior Knowledge" 88% of the participants said that they did not know anything about governance when they commenced business.

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However, six of the participants (27%), who claimed they knew nothing about governance, did exhibit a tendency towards good governance:

I didn't have technical knowledge but I do know that you have to be hands on sometime and you have to really take care of the business… talking to other business people that's how I know about informal governance. (R4)

In relation to "Early Learning" we went on to investigate whether all participants attempted to better themselves in governance practices. In particular:

1. How their initial level of knowledge translated into actual governance practices,
2. What they learned about governance whilst on the job, and
3. Whether they took action to change/improve the situation.

The following feedback was commonly observed:

It was really learning from scratch. There was a huge difference between managing the place and actually writing out the cheques and getting our head around the accounting and that side of things. I have learned to be reasonably conservative in terms of what we do…as a team you know… we play it safe. By looking at… where others failed or where others went into trouble. (R19)

The participants acknowledged that they made mistakes when they first started because of a lack of knowledge of governance (80%). Two of the three

participants who were no longer in business, attributed their past business failures to lack of knowledge. Others admitted that if they had known about governance from the start, they could have avoided mistakes (80%):

Although I knew about policies and procedures, I didn't have a clear picture like today. We had procedures in place; we had to because of the hygiene and such… But I didn't really have the knowledge of today; that would have had me… on top of everything. (R9)

Back then I did not think it's needed. It was an inconvenience. Looking back, now I know how a proper board structure works… if implemented correctly. I don't think they will impair you too much… The benefits of having them outweigh the costs. It's hard for SMEs to see, if you don't know what you don't know. (R14)

Most participants showed that they took action to improve governance practices when they realised they were in trouble:
You know… this isn't right. So I made a few changes… Long term I am restructuring all those roles. Getting in a new administrator and then setting up an advisory board... We reduced our rent, reduced our staff, changed a few things and since then we've, turned it a little bit in the black. (R1)

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The participants were then asked about their current understanding of governance and, whilst the responses varied, most recognised the need for systems in governance.

I would take it to mean to govern something, to sit in a decision making role. Looking for directions and opportunities and making sure that the systems and the procedures that you put in place… are being adhered to and maintained. (R3)
I know in governance that you have to have your policies and procedures in place, to measure, to be in control, to know where you're going. (R9)

Governance is like I have got systems in place... Things like making sure that I am well capitalised, making sure that I am not over spending…Making sure that I run things past lawyers and accountants. (R16)

In regards to research question 2: What are the potential benefits of SMEs adopting good governance practices? We wished to learn about:

1. The perceived importance of governance and the impact governance has on the success of a business.
2. Benefits of governance i.e benefits that owners experienced after implementing good governance practices.

The responses gathered indicate that governance is important (100%). However, how owners rate governance, compared with other matters, differs:

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When you start, you need somebody who is really passionate. As the business grows, that's the time for governance…yeah you need to be smart, be realistic. But in terms of having formal draconian governance like a board, if you are too small I don't think it will work. (R16)

I think I should say… 100% governance. If that was not there we would not have been here now. If I don't come to work here or if I go away …I know that everything would be slack or everything would be behind. So governance and my presence and constant supervision is everything… (R24)

Table 2 shows other factors that some participants rate higher than governance.

Table 2: Important Factors

Important Factors	**Participants (Total=11)**
Passion & Entrepreneurial Spirits	R8, R16, R25
Expertise and Skills	R2, R5
Focused and Capable Owners	R13, R14
Flexibility	R18
Good Support System	R21
Day to day Management	R19
Confidence	R4

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We asked the participants to describe the success factors of their business (Table 3). We wished to see whether they considered governance practices had contributed to their success; we feel that the responses, especially "Good Systems and Communications" show that many had.

Table 3: Success Factors

Success Factors	Participants
Customer Service	R1, R2, R5, R10, R15, R19, R23, R24
Good Systems and Communication	R2, R6, R7, R10, R17, R22, R24
Valuing staff	R1, R4, R7, R19, R21, R23,
Owner factor	R2, R13, R14
Passion	R7, R8, R16
Quality product	R5, R12
Goal oriented	R11, R22
Flexibility	R18
Creativity	R3
Commitment	R7

Many of the participants explained how the implementation of good governance systems had led to their personal development:

If you don't change or grow… that's the mistake… you must reflect on what happened and what went wrong… If you don't open your mind up to the fact that you did screw up… that's how I learnt from my job… (R1)

Yes, I do see the benefits because it makes you look at things again, makes you step back and review like the structures and things, about how you are doing things… opens you to different ways of thinking. (R12)

The beneficial effects of good governance practices on business performance were also widely recognised:

But the real value of governance is strategic guidance… Do I spread this model out around Australia or...? Do I need to divest some of my portfolio or… Do I carry on paying the debts? Governance helps on that. (R16)

If proper governance practices are employed, it helps with running the business better. More efficiently and in a better way... (R23)

It establishes clear understanding and clear chain of commands in any business… People, everyone then work on that pace you know. Otherwise everyone will do their own thing. Now they know what kind of job I expect from them. So when I asked something, it is done. (R24).

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Finally we collected data concerning research question 3: What are the barriers preventing SMEs from adopting good governance practices? The responses revealed two types of barriers, physical and psychological. The major physical barrier identified was lack of support (80%):

I didn't know how to run the business…and we didn't have much advice, and we didn't know where to get it because we didn't know how to speak English. It is so hard to start and do everything properly. (R5)

The problem with start-up is that you usually have low capital and because of that you can't attract the current support level that's required. In a growth company it is important to have good people around and you can't always get those people from the start. (R18)

Some participants suggested how to improve external support for SMEs:
I think government should… before people can start a business… make them attend a course… like a little MBA, really important thing like financials how they go about good business and what they have to do. If they can't afford that course, how can they afford to run the business? I think the biggest problem is that people run a business but don't know what to do. They don't know about the governance side. The government should train them before they start the business. To give them advice that they need even though they may not think they need. In Germany we have to. (R5)

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I would suggest the best thing to start them off is with a mentor… That would be my first step to suggest to SMES, to always have independent mentor to come and look at the business. It is nice to have another business type person on the outside looking in. (R14)

Some (72%) saw a lack of knowledge of governance as the barrier to implementation of good governance practices:

They are passionate about their product but not knowledgeable about running the business…They don't know the fundamentals and often fall into the traps. For instance trying to increase the turnover and not worrying about your bottom line. (R14)

A lot of small business owners are technical experts in their own areas but may not have a good overview of business in general, or tax, or commercialism or what have you. (R21)

Another physical barrier is financial constraints (56%):
Mainly cost. Cost, knowledge, not knowing about the benefits. We just recently changed from having 12 board meetings a year down to 6. We estimated the cost at around $125,000 a year. That's a substantial amount off your bottom line for SMEs… (R14)

One is cash flow issues. And that is coming again from not having enough support for the owners cause most business are family based, or one person own it. (R22)

Some participants (56%) claimed to be too busy to focus on governance:

The biggest problem is the lack of time to put it into practice. Even if you have got all procedures in place...I think often the tyranny of business is a thing that affects many smaller businesses and what should happen in practice don't happen because they were too busy trying to earn the money. (R17)

Our literature review suggested that corporate governance cannot be applied rigidly to SMEs due to the different dynamics between the owners and operators.

One participant commented:

I wanted to do that but "M" did not want to do that. So it didn't work. It's a family business…like you cannot really say we are going to do this or I kick you out. That was because we work closely together… He did the operational side. I did all the administration side. I couldn't work without him or he couldn't work without me. However we cannot say we have to do it now or it wouldn't have worked. It's hard. It's so hard to implement governance. (R5)

A couple of respondents mentioned "capacity" as a barrier to the implementation of good governance:

I suppose, one word will be capacity. They (SMEs) try to spread themselves very thinly on the ground. And they get away from their core activity. (R13)

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In our opinion being unaware of one's own capacity is a result of a lack of governance. The matters requiring attention are the factors affecting capacity (such as time, knowledge, support, etc.).

The second major group of barriers are psychological. Recurring themes are: owners' resistance to change, and gaps between how owners wish things to be and how things are in practice. Perceptions are difficult to change without constant effort from the owners and others around them.

I'm quite suspicious of other business people. I fear because people who have become involved have caused problems. I am lacking trust in the motive behind other business people… (R2)

He finds it really hard to adjust to things and stuff. He does everything his way. So working together with him is quite hard. He is reluctant to change. And he knows he does things right so he doesn't think he needs to change. (R5)
Some (24%) feel they will lose control if they let external people be part of the business:

One of the things (barriers) is… inviting someone else in to the business. People sometime think they don't want other people telling them what to do. I have got information flowing in and ideas coming in but I am still nervous about giving out too much information. (R12)

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However, around half of our interviewees disagree, for example:
No, as long as the property is managed properly. We have given away some controls to the property manager. So as long as the property is managed, we don't care… We could concentrate doing other stuffs. (R6)

The fact that SME owners need to juggle so many things is another psychological barrier:
In actual fact you are doing, instead of a whole lot of one thing, you are doing a lot of everything and things get confused. I can be the delivery boy this week and next be the rubbish boy, then strategic decision maker. I wear too many hats which doesn't allow for good governance because it's very hard to govern when you are running around doing the work. (R3)

If you have been working for someone else and then doing your own thing. You have to start to do a lot of things that you just wouldn't have considered… But if you are going to work for yourself and you want to get result…its long hours and hard work... There's no way around it. (R10)

64% of the participants mentioned that too much governance can stifle creativity:
I had concerns about who would be on the board. I had thoughts that because the company was small, it would be too much of structure and actually slow the business decision making down. (R2)

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I also think… like a textbook approach to things, can stifle creativity and entrepreneurialism. Sometime it's amazing what you can achieve if you don't know what the risks are. I don't mean to say that you should be reckless, but if I had a full board of directors, I wouldn't be able to make any decisions, I would have analysis paralysis. I need the flexibility to grow. (R16)

However, some participants disagree, "good governance and good procedures should allow the business to get on and function properly" (R17).

Discussion

An interesting finding was that most participants did not know anything about governance when they first started. Table 1 shows that 72% of the participants have been in their current businesses longer than 5 years. As governance was not an immediate concern for them, it is interesting to recognise that they have survived. Perhaps they offered particularly strong products and/or services. When asked about this, the participants revealed that what fuelled them in the beginnings were "youth, energy and the enthusiasms coming from being their own boss". However, such factors can only take businesses so far. Our interviewees recognised that there were incremental progressions of learnings as they grow their businesses.

Our research revealed that lack of governance was the main factor identified as being responsible for past mistakes. Our interviewees largely recognised that their

ability to adapt and improve their governance practices had allowed them to ride out the bad times. Those that had failed recognised that lack of good governance had been, at least partly, the cause of their failures. The learnings of governance for our respondents had been largely organic (through trials and errors) although a few had obtained some academic knowledge of governance. Learning through trial and error can be a very expensive exercise for these owners and often lead to business failure. Governance is about making good decisions. It is imperative to find a way to encourage SMEs to adopt good governance practices early. There is a need for easily accessible, good educational packages.

Our research found that governance plays an important role in the successful running of any business. However, our participants had varied views as to how important governance is compared to other business variables such as the skills and expertise of the owners. 56% of the participants put governance at the top, but some only view it as a complementary concern, of lesser importance than other variables such as: passion, or their skills and expertise relating to the product/services that they offer (44%). There is no right or wrong answer with regard to what is the most important determinant of business success. Our view is that governance is not always the most important factor, but it is definitely a potent and indispensable factor, which helps ensure good decisions are made.

If you have people who know about governance but don't have the skill or expertise, how do you do the business? If you have the skills, you can run the

business up to a certain point. They may get stuck and not growing and that's where governance comes in. (R5)

Table 3 indicates that, whilst our respondents, didn't specifically mention governance as a success factor, their answers are what many would consider to be results of good governance practices. With respect to the actual benefits that governance offers, there are two types of benefits (Tables 4 and 5).

Table 4: Personal Improvements

Personal Improvement	Percentage	Participant
Personal Growth	12%	R1, R12, R16
Self-Analysis	12%	R11, R12, R16
Better Decision Making	8%	R2, R22
Inspired	4%	R1
Stress Management	4%	R2
Confidence	4%	R5
Insights	4%	R7
Different Perspectives	4%	R7

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Table 5: Business Improvements

Business Improvement	Percentage	Participant
Strategic Guidance	40%	R1, R2, R8, R11, R12, R14, R16, R18, R20, R21
Better running of business	40%	R7, R9, R10, R13, R15, R17, R19, R21, R23, R25
Good Controls	16%	R6, R7, R8, R24
Helps with planning	8%	R4, R8
Accountability	8%	R22, R25
Longevity	4%	R3
Solid Foundation	4%	R3

The findings show that governance does have relevance to SMEs, although implementing governance practices in SMEs may not be simple because of the varied situations/conditions that SMEs are facing (e.g. blurred lines between ownership and controls, comparative size, etc.). We do feel that owners are becoming more aware of the need for good governance; many have become willing to set aside ego, for the betterment of the business.

Recommendations

There are barriers to the adoption of governance practices by SMEs, many emanating from fear of the possible consequences. However, such fears are unwarranted if SMEs implement governance practices properly. From our limited

research base, we list four recommendations below; further research will be required to substantiate these. However, we believe these recommendations would create an environment encouraging good governance practices by SMEs. These would benefit SMEs' performances, and that of the New Zealand economy:

1. Create a nationwide body driven by the NZ government to bring governance awareness to SMEs. Collaboration from: the government, the universities and relevant professional bodies is required. This body must develop good governance programs/frameworks which inspire the development of the best of cultures in SMEs, to achieve sustainability and success.

2. The government should consider making a governance certification compulsory for potential SME owners, before they commence business. This would improve the confidence of the owners. Obligatory, periodic certification "refresher" courses on governance should also be considered.

3. In New Zealand, both schools and universities should provide more education relevant to SME governance. This would help with early immersion and awareness of good governance practices.

4. In regards to good governance practice that can be applied by SME owners, we recommend the creation of an informal advisory board. The board will act as an independent advisor for the business in their decision making processes and provides an avenue to sound-off ideas prior to implementation. The board members

should be staffed by appropriately qualified people preferably on areas that the owners considered lacking.

If these recommendations can be developed properly, they will convince SME owners of the need to employ good governance practices.

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The Governance Challenges for one of the largest Global Dairy Exporters – Is a Co-Operative the best model for Fonterra?

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Executive Summary

Fonterra is the world's largest exporter of dairy products and the fourth largest dairy company in the world responsible for about a third of international dairy trade (Rabobank, 2002). Based in New Zealand, Fonterra operates in 140 countries through its two main subsidiaries NZMP[167] and New Zealand Milk.[168] As a co-operative, Fonterra is owned by its 10,400 supplier/shareholders who can elect directors and shareholder councillors to govern and monitor the company. Since its formation in 2001, Fonterra has continued an aggressive programme of acquisitions, joint ventures and worldwide alliances whilst simultaneously undertaking an innovative capital restructuring process. Funding this aggressive growth strategy as well as maintaining and improving various debt to equity ratios has not met with all shareholders' approval.

[167] NZMP – dairy ingredients.
[168] New Zealand Milk – consumer products.

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Fonterra's domestic milk supply market share has fallen from 95% in 2001 to around 87% in 2014 and as more overseas competition move into the domestic market this percentage is expected to drop even further (Patterson, 2014). As New Zealand Milk has continued to grow in real terms, Fonterra has been shielded from this drop in percentage. But the quantity of milk that New Zealand produces cannot grow forever and this is expected to plateau in the near future.

If farmers continue to leave Fonterra for other companies, can Fonterra continue to assume market dominance and the setting of the national milk price? If Fonterra was unable to continue in its current structure, what risks does this pose to all farmers and the dairy economy? In order for Fonterra to maintain supplier/shareholder loyalty it must maintain and improve upon current performance, but will also need to invest significantly into research and development as well as into innovative products in order to boost the value added returns to shareholders. In order to meet these requirements it could look at changes in ownership structures to free up additional capital. Fonterra is a major component of the New Zealand economy at present, however through lack of communication to both shareholders and the public this is not well understood which results in a general lack of support.

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Introduction

Fonterra was established in 2001, and was essentially a merger between New Zealand Dairy Group (NZDG), Kiwi Dairy Co-operative and the New Zealand Dairy Board (NZDB). This merger saw the simultaneous removal of the NZDB's statutory exporting monopoly and therefore the deregulation of the New Zealand dairy industry which required government intervention to ensure approval by the Commerce Commission. There were some smaller milk processors who chose not to amalgamate, notably Tatua and Westland, but overall the new Fonterra Co-operative accounted for approximately 95% of the New Zealand milk supply (Fonterra Co-operative Group, 2003). The strategic reasons for the amalgamation which created Fonterra were encapsulated by Fonterra's first Chairman John Roadley in a speech to a Ravensdown conference in 2001:

"The more immediate challenge and opportunity that I am focussed on is ensuring we respond well to the globalisation of our dairy industry… That's driving the acquisition of dairy companies already working in protected markets, and the alignment with them in joint ventures. The other key driver for industry consolidation is globalisation by our customers. The top 25 food retailers in the world – our customers – are now involved in a dozen or more major acquisitions annually… You must have scale to have any leverage with a customer as powerful as a Wal-Mart. That reality is driving dairy companies to merge, to acquire and to enter into joint ventures with one another… That's the dynamism of the international dairy industry that we are part of. There are going to be fewer and

fewer, but bigger and bigger companies chasing milk supply and customers." (Roadley, 2001)

In global terms Fonterra is the world's largest exporter of dairy products, and the fourth largest dairy company in the world (Rabobank, 2002) responsible for about a third of international dairy trade. It operates through its two main subsidiaries, NZMP (dairy ingredients) and New Zealand Milk (consumer products) in 140 countries. Since its formation Fonterra has continued an aggressive programme of acquisitions, joint ventures and alliances worldwide, whilst simultaneously undertaking an innovative and controversial capital restructuring process.

However despite, or perhaps because of these changes, Fonterra's market share of New Zealand milk supply has declined from approximately 95% in 2001 to around 87% in the first six months of 2014 (Patterson, 2014). Of the four different co-operative models identified by Stranskov (1996), Fonterra is adhering to the large farmer controlled co-operative model supplemented with addition finance from outside institutional investors in order to fund this aggressive growth strategy as well as maintaining and improving various debt to equity ratios.

The New Zealand agricultural industry has changed dramatically from being a highly regulated and subsidized industry to the only non-subsidized agricultural industry in the world (Lattimore & McKeown, 1995). There has also been consolidation of farms so land is increasingly being dominated by fewer and larger

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farms (Mairi, 2006), and as such there is significant capital invested with each farming entity. Fonterra has been formed to prosper and advance in the new world of customer globalization, and as a vertically integrated co-operative need to maximize profits and margins in order to provide a good return for its shareholders. It is commonly reported that Fonterra alone makes up 7% of New Zealand's GDP, and approximately 95% of its earning are generated outside New Zealand by direct sales to more than 100 countries through a network of international processing and distribution investments. Fonterra is a private company, co-operatively owned by its 10 600 farmer shareholders who supply the milk and has 16 000 employees (6000 of these offshore) (Gray & Le Heron, 2010).

Fonterra has 35 manufacturing plants outside of New Zealand, which receive and process milk externally sourced as well as dairy ingredients supplied from New Zealand in order to manufacture a diverse range of dairy products. As Deputy Chairman Greg Gent noted in 2001, "If Fonterra wants to sell (offshore) yoghurt and semi-fresh high value products it needs to use non-New Zealand origin product. You can't export water profitably so it makes sense for us to source these ingredients from other suppliers". This approach has resulted in the development of a number of strategic joint ventures and alliances with other dairy processors and manufacturers such as Nestle, Dairy Farmers of America (DFA) and Soprole in order to maximise foreign returns from what is essentially a commodity product.

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The sheer size of Fonterra in relation to the New Zealand business landscape, and the fact that it also operates as a co-operative appears to frighten a number of politicians. This could perhaps be best described by Akoorie and Scott-Kennel (1999), "co-operatives (certainly in the New Zealand context) are seen as a less desirable form of enterprise organisation, or an anomaly in a hierarchical capitalist world. Their monopoly powers (it is suggested) stifle innovation, create inefficiencies and act as a barrier to competition, which as Crocombe et al. (1991) suggested is critical to the development of international competitiveness. On the contrary, we would suggest that the co-operative structure may be best suited to the nature of the agricultural industry in which it operates". While politicians and analysts best debate how Fonterra should be operated, and argue how the co-operative model may lead to inefficiencies, Gentzoglanis (1997) examined the relative performance of Canadian dairy co-operatives to Investor Owned Firms (IOFs) using data from six major dairy co-operatives and six IOFs from 1986 to 1991. His results contradict the theoretically expected relationship: specifically, the co-operatives have a higher profitability, higher liquidity, and lower leverage than the IOFs. These studies however fail to address the difference in financing the co-operative's capital and the financial viewpoint of the owners of the co-operative, that is, the members. (Rafat et al, 2009) This issue was identified and addressed by Fonterra through the Trading among Farmers (TAF) initiative which in 2010 allowed for outside finance to invest in Fonterra shares to enable a profit share and a capital gain or loss.

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Indeed while Fonterra may be accused of being a monopoly or using monopolistic behaviour (Fox, 2010) domestically, in the global context Fonterra is only the fifth largest dairy company worldwide (Gray & Le Heron, 2010) in what is a traditionally a very competitive market. In a New Zealand context Fonterra, as well as all other dairy processors and manufacturers is subject to the Dairy Industry Restructuring Act (DIRA), which in its current form Fonterra is legally obligated to supply start-up competitors (most of which are foreign owned) milk at cost price with conditions that are beneficial to the competitor and then allow for the competitor to export in direct competition to Fonterra. In the first full dairy season following Fonterra's formation the company collected 96% of New Zealand's total milk production. But over the intervening years, Fonterra's market share has steadily declined. By the 2013 dairy season this market share was 88% and over the first six months of the 2014 season this share had slipped further to 87% (Patterson, 2014).

If the co-operative structure that currently is Fonterra failed or fragmented in any way, and left farmers to fend for themselves in the current free market; it is thought that a distinct change in farmer behaviour would occur. This is perhaps best described by Nuffield Scholar Desiree Reid (2011) when she noted "The removal of collective ownership and marketing encourages farmers to act individually. They are economically led to make short-term decisions for themselves, rather than for the whole industry and for the long-term. This individualist behaviour restores the inherent inefficiency in the dairy value chain, and results in a poorer financial

return in the medium term. This decision of individualism versus a macro-view is similar to the proposition of contract milk in Fonterra. In the short-term contract milk is economically attractive for the individual. Supplying milk on contract can be more profitable because the capital investment in processing assets is not required. However, if all Fonterra farmers acted individually and supplied under contract, farmers would no longer own Fonterra. As demonstrated by the experience in the United Kingdom, the focus of the processor would likely shift, and maximising Milk Price would no longer be an objective."(p. 7). If this scenario were to occur, it is my belief that dairy farmers would no longer have any form of control and would have to accept whatever price the processor offered. With dairy farmers already highly leveraged as a group, this would place extreme financial pressure on many farming businesses as New Zealand Reserve Bank Governor, Graham Wheeler (2014) explains, "The elevated debt level means that some farmers are potentially highly exposed if there are substantial declines in the milk price pay-out, or if land prices fall. With dairy production techniques becoming more intensive and with a higher cost structure, the implied 'breakeven' pay-out for individual farm profitability has increased over time. A significant decline in the milk pay-out, for example, could place some highly indebted farmers under financial strain, particularly with the market for farmland being more illiquid in times of stress. Higher debt levels mean that farmers are also exposed to rising interest rates, especially with close to 70 percent of dairy debt comprising floating rate mortgages."

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Another risk for Fonterra's future relates around the loss of reputation among customers, particularly around food safety and security. This was perhaps best demonstrated with the recent Whey Protein Concentrate (WPC) 80 scare, but the brand has also been threatened with a subsidiaries fatal melamine contamination and a DCD scare. Perhaps to Fonterra's detriment, there is countervailing evidence that suggests "liability of a good reputation" (Rhee & Haunschild, 2006). That is, being known for something can lead to enhanced expectations that may be hard for the firm to meet. For example, Rhee and Haunschild (2006) study suggests that having a good reputation for product quality may result in greater market share losses following product recalls (in particular, automobile recalls resulting from severe defects). (Lange, et. al, 2011). This combined with a sensationalistic media can exacerbate and amplify any possible quality mishap in the eyes of the consumer.

Facts / Data

All respondents were concerned with the impact on the New Zealand economy if Fonterra was forced to downsize or fragmented completely. A leading Australian dairy authority compared the impact to mining in the Australian economy:

"I saw with interest the other day when GDT[169] went up, whole milk powder went up 25% and your dollar went up 2 cents. The impact of Fonterra on the New Zealand economy is like the mining industry here. New Zealand created Fonterra,

[169] GDT – Global Dairy Trade Price Index - weighted-average of the percentage changes in dairy prices.

it's something a little bit special, and you need to do whatever you can to protect that, and your farmers probably need to understand the world doesn't end at New Zealand, have a look outside New Zealand and look at other co-operatives around the world and what happens to the dairy industry in that country when they lose their co-operative…I think the farmers need to understand what happens when you do lose it."

Another view from the banking sector:
"If it (Fonterra) failed that would catastrophic, it would be catastrophic for the New Zealand economy and if you take Nokia as the example in the Finnish economy - Nokia was the Finnish economy."

The loss of supplier/shareholder control and the breakdown of the co-operative business model are of real concern to farmer respondents. That is, where the company's priorities shift from maximising milk price returns to its suppliers to maximising profit for its shareholders. In the corporate model the shareholders are not always farmer suppliers. This concern was expressed by an Australian farmer: "I think it's really important that you hang onto that co-operative structure for your success in New Zealand. Because once you start to lose that you become another pawn in the market and I think that if I was a New Zealand dairy farmer I'd be promoting the value of the co-operative to your farmers…use the Australian industry as an example - if you don't protect your co-operative as to what can actually happen."

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Respondents raised the possibility of a milk supply plateau. If that occurs, Fonterra's diminishing market share will result in a tipping point where the company will be unable to fully utilize existing "There's definitely a tipping point, and I made the example where we're really the only model being a co-operative that will pay the farmers the most they can. The corporate model pays less, if they didn't, they would have their own milk price independent of ours and they would be trying to bump us off in terms of milk price - but they're not they're just paying enough to get milk."
plant and capital assets to provide a competitive return to supplier/shareholders. As described by a current Fonterra director:

As a result of falling milk supply through loss of market share and increased competition, there would be a tipping point where the underutilization of existing assets begins to undermine any value gains and/or returns to shareholders and this could create some difficulty for Fonterra to return the best possible value back to shareholders due to the increased overheads. Although a number of figures were mentioned with 80% of milk supply seen as a psychological tipping point for the company, most of the respondents indicated that Fonterra's market share would eventually drop to 70-75%, with possibly up to 10-12 dairy companies collecting and processing milk by 2020.

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A Fonterra Shareholder Councillor also commented that Fonterra "have to fight for every litre" or they risk losing their "comparable advantage, losing the one advantage you have which is temperate climate lots of water and low population." The only way identified to mitigate this scenario was through performance.

As a former Fonterra director says:
"Easy to say, not so easy to do. I still think that performance is the only way. You can complain about this or complain about that but around scale and around influence Fonterra should be untouchable by other scale ingredients players."

However, with recent volatility in the commodity milk markets, this has shown that Fonterra needs to move away and diversify from bulk commodity products into more specialised, value added products that are not subjected to the extreme price fluctuations of commodities. As one of New Zealand's leading agricultural finance specialists noted:
"The one part of the Fonterra business that I think is exceptional is the food service business. What they are doing in China in food service is exactly the right thing to be doing. They are delinking from commodity and really focussing on delivering solutions to customers and those solutions don't need to be for the end consumer they can be for the intermediate product they just need to be innovative and different but I think if we are going to play in the commodity game, as I said 5 years ago, others will pass us as they can do bigger volumes at lower cost."

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The share capital required to supply Fonterra is perceived to be a large barrier to entry into the company for many potential suppliers and for existing shareholders this has been an easy source of capital to be released. Some respondents believed a combination of this and a dissatisfaction among some shareholders around the value of the share dividend that has perhaps led to more Fonterra supplier/shareholders being prepared to look seriously at other opportunities. It was thought that Fonterra's overly zealous approach to capital restructuring into the Trading among Farmers (TAF) model has isolated them and desensitized directors and management to other equally pressing and valid shareholder concerns.

Data Analysis

The research showed that three key risks could potentially threaten Fonterra's future viability. The first is Fonterra's falling market share in domestic milk supply. When Fonterra was formed in 2001 they were responsible for collecting and processing approximately 96% of the New Zealand milk supply. In 2014 this percentage had fallen to 87% and it is expected to decline further. This has been brought about by the advent and increasing number of foreign owned corporate processors who have been able to exploit niche markets and selectively recruit milk suppliers who meet their own specific criteria. In real terms the amount of milk Fonterra currently collects has increased and as a result the company has been buffered the effects of losing this market share. However, all respondents in the

research agreed that New Zealand milk supply would plateau in the near future making this a major concern to Fonterra. Likewise, the respondents agreed that the advent of domestic competition had resulted in Fonterra's falling milk supply share and that the only way to combat this would be for Fonterra to *outcompete* rival processors in terms of performance and payout. This could be extremely difficult due to the smaller company's niche requirements and Fonterra's legal obligations.

The second risk identified is the possibility of political interference that could dramatically impact Fonterra's performance and/or viability. Due to Dairy Industry Restructuring Act 2001 (DIRA) obligations and the requirement to collect all available milk, Fonterra must have enough processing capacity to cope with peaks of milk flows which can be approximately 92 million litres/day. As a result, Fonterra is forced to convert this raw product into basic commodity products like whole and skim milk powders in order to assist processing throughput. This has serious implications for a company that has plans to increase value added products and reduce exposure in bulk commodity markets. Under the same legislation Fonterra is legally obligated to supply/subsidise any new competitor in the New Zealand domestic market with up to 50 million litres of milk annually and a predetermined market rate for a minimum time period of three years in order to assist competition and provide choice for farmers and suppliers. Under the original legislation, this requirement ceased when Fonterra's market share fell to 88%, however in 2009 it was determined by government that this should be recalibrated to 80%.

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The third risk identified is the loss of customer reputation and how the resultant loss of sales or reduced premium for products would impact on financial performance and viability. This was perhaps best illustrated with the 2013 Whey Protein Concentrate (WPC80) quality recall where tests showed the presence of botulism in milk powder and the resultant scramble to track and quarantine affected product. In the end the test was actually a *false positive* but the haphazard way and poor communication with which the recall was conducted caused a major breach with customer confidence with which Fonterra is still affected and suffering from today.

As dairy farming has evolved into a much more intensive and diversified business, possibly since the days when wives needed to work off farm to supplement a low dairy pay-out, the farmers and agri-business owners have become more aware and demanded a better return on capital. Mechanisation has improved productivity and with these added infrastructural costs farmers have become more aware of opportunity costs on capital invested. To help grow their equity and diversify their risk dairy farmers are more inclined to look at other investment options. Fonterra has some pressing concerns to recognise and mitigate in the short to medium term, and this research potentially identified a number of options that the company could consider.

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Conclusions / Recommendations

With the formation of Fonterra the New Zealand dairy industry changed forever, however Fonterra has not reached its potential or delivered on its promises. With competition increasing domestically and globally, Fonterra cannot afford to become complacent and must ensure that its supplier/shareholders continue to receive the best possible returns for their milk and to show this in a transparent manner.

The real issue for Fonterra, to maintain critical mass and shareholder support, is being able to maximise the value of milk so that it can generate an acceptable return to shareholders both now and in the future. All survey respondents unanimously stated that for Fonterra to maintain shareholder and supplier support, it all came back to performance. If it was perceived that Fonterra was not performing well, shareholder flight was inevitable. Although Fonterra's market share of New Zealand milk has declined over 14 years of operation, in real terms this volume had actually increased and had buffered the company from any adverse effects. However, what does Fonterra do when the New Zealand milk pool plateaus?

To reduce exposure to the volatility of world commodity markets, Fonterra needs to invest more into innovation and research and development to access the higher value premium markets. While innovative research and development is essential

for Fonterra, they must also continue focusing on being world's best in the ingredients business to maximise current returns for shareholders while using joint ventures to minimise the costs of entering new markets or promoting new products. If Fonterra stays in the milk powder commodity markets then in twenty years there will be overseas competitors who could produce more milk at a lower cost. The assertion is that Fonterra needs to continue growing value added premium dairy products to better serve both customer and shareholder. If this requires a change in business structures such as joint ventures or other type of alliances then this is seen as a positive move for the co-operative.

Retaining milk supply will require the company to adopt a more personable approach with its day-to-day dealings towards shareholders. To a certain extent Fonterra has recognised this and has put in place some measures to try to bridge that gap. An example of this is the Farm Source initiative that is currently being rolled out and breaking this down into regional level so localised concerns can be addressed. The benefits of this initiative need to be better explained to shareholders and constantly reinforced so that a better uptake can be achieved.

It was generally accepted among respondents that Fonterra has an extremely important role to play within the New Zealand dairy industry. Specifically, being able to effectively determine the national milk price through economies of scale as well as being able to calculate what an efficient milk processor should be able to produce for a set quantity of product. If New Zealand farmers lost the opportunity

to be members of a dominant co-operative like Fonterra and the marketplace fragmented into a number of smaller corporates then there is a high probability that farmers' financial returns would be worse. With no national milk price to be benchmarked against, corporates would only have to pay their suppliers whatever was required to keep them in business with no obligation to maximise supplier returns.

This would have a devastating effect on the New Zealand dairy scene with many farmers forced out of business due to low returns and many placed into a position of negative equity as the value of their land reduced over time as the realisation of lower returns filters through the industry. While most farmers would survive, in reality they would have to be in populated dairy areas with easy access to a processing plant or they would be refused pick up and dairy farming would struggle even more to entice people into the industry when the perceived benefits have been substantially reduced. Overseas experience has shown us that when farmers lose control of their industry, they lose their collective voice and ability to collaborate and determine conditions other than price.

As well as the value created within the dairy sector, there is a multiplication effect right through the entire breadth of the New Zealand economy and this needs to be better communicated. The respondents agreed that if the dairy sector lost approximately $5-6 billion (NZD) dollars in revenue, there would be a ripple effect

on the economy that would create some adverse effects for government and private sector alike.

For these reasons New Zealand must retain a Fonterra type of company in the dairy industry so that value is maximised and kept within New Zealand for the benefit of all New Zealanders. In order to remain relevant, Fonterra needs to:

- Communicate better with shareholders and especially customers to determine what their needs truly are,
- Invest in more research and development so that new innovative products can be made in order to enhance value, and emphasis the science behind the product. Especially important in order to "futureproof" the company and reduce exposure to commodity markets,
- Continue to maintain the highest quality food standards and improve product traceability to world's best,
- Continue to develop new markets and products through the use of joint ventures in order to minimise risk and costs.

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