

Just Compensation in Expropriation?

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ABSTRACT

In the western societies based on private ownership expropriation of private property for the public good has been enabled by legislation. Such legislation may have issued from the hindrance of developments required for the public good caused by the landowner, possibly in a monopolistic position, when refusing of a voluntary transfer of his land or claiming for an unrealistically high compensation. Another reason may also have been to ensure the efficiency of land acquisition.

According to legislation the determination of just compensation is the principle rule for expropriation of property, i.e. paying such compensation that the landowner's financial situation will remain the same despite the expropriation. In the Finnish condition this traditionally means a market price calculated from comparable real property transactions. This raises a few questions, which may even be of general interest:

- How well does the statistical price determined according to comparable transactions compensate for the losses?
- Will the compensation statutes, valuation methods and manners really lead to just compensation?
- How just will it be if the expropriator gets the whole profit from a property, especially when expropriated by private quarters mainly for private purposes?

The article is treating the situation mainly from the Finnish and Nordic tradition, but also aims at considering the future in a wider sweep. Only compensations to the owner are treated.

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1. INTRODUCTION

A basic characteristic in the market economy is the well protected right of ownership. Should the property not be protected the owner might not be willing to take the risk and invest on the property, as someone else would possibly get the benefit, not the owner. The lenders would neither be willing to lend money for this kind of risky investments. Without investments the development of societies is seen too slow and ineffective. For that reason, the ownership of property is protected in the constitutions, e.g. in Nordic Countries. This has also been incorporated into the First Protocol to the European Convention for the Protection of Human Rights and Fundamental Freedoms. It is stated in Article 1 that “Every natural or legal person is entitled to the peaceful enjoyment of his possession”.

The right of ownership, however, cannot be unlimited, but the right to interfere, when necessary, has been reserved for the society. There are normally strict preconditions for such interfere, so that the functions of the free market would not be harmed as even can be seen from the above mentioned European Convention which continues “No one shall be deprived of his possession except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties”.

In the western societies based on private ownership expropriation of private property for the public benefit has been enabled by legislation. The idea originates from the French revolution in 1789 and the Napoleonic law on expropriation of 1810, although the concept of expropriation is much older, e.g. already known in the Roman society (Wiiala 1966 p. 17; Hyvönen 1976 p. 3-4). It is seen necessary to limit private rights when required for the public good. This will also benefit the private sector when only the private losses are compensated. The landowner would otherwise, due to his/ her monopolistic position be able to block development when refusing voluntary transfer of his/her land or claiming for an unrealistically high compensation. A part of the landowners may also, for one reason or another, be missing or legally incapacitated, due to which some sort of compulsory measures are required in any case. Another reason for expropriation is the need to ensure the efficiency of land acquisition. Especially prior to the modern data registers and equipment the control of projects encompassing large areas has been very laborious.

Expropriation is not, however, the primary method for land acquisition, but presumes that the acquisition has not been possible in any other way. For example, it is stated in the Finnish Act on Expropriation (4 §) that expropriation shall not be enforced if the purpose of the expropriation can be achieved in some other way as well. In Germany the State shall choose a method with minimum harm for compulsory acquisition (Fickert 1991; Peltola 1997). This

means, for example, that land readjustment has to be used instead of expropriation if it fulfils the objectives desired. Further, it is stated e.g. in Finland that expropriation shall not be used if the inconvenience to the private outweighs the public advantage.¹

2. COMPENSATION

The critical point concerning expropriation is the question of compensation. According to legislation the determination of compensation is the principle rule for expropriation of property, i.e. paying such compensation that the landowner's financial situation will remain the same despite the expropriation. Non-economic values will not be compensated (Wiiala 1966 p. 56).

In the Finnish and Norwegian legislation the term "full compensation" is used whereas in Sweden and England such a term has not been used explicitly (Korhonen 1997 p. 131).² But what means "full compensation"? According to Korhonen (1997 p. 131) the rules for compensation in Norway and England may, depending on the case, guarantee the owner better compensation already in the first instance than in Finland and Sweden. For example "in Sweden only the present use of the property is compensated and all expectations based on the changing use of the property must be ignored". "In England the future development value of the land is taken into account in the assessment and thus all such development of the land which would have been permitted to the owner shall be taken into account." On the other hand Denyer-Green (1998 p. 5) from UK writes that "There is a rather crude relation in this country between the measure of compensation (if any) and the use of the [compulsory] powers."

In reality the concept of "full compensation" depends on the legislation in each country. There are no strict rules, for example that the owner has to be able to purchase a similar property for the same price, although the basic idea of compensation strives to this (Hyvönen 1998 p. 407, 409-410)³. Normally this can even be excepted. No one should be poorer because of expropriation but also not richer (Wiiala 1966 p. 22). Further this means that also the increase of the value of an expropriated owner's retained land shall be taken into care in assessment.

According to Wiiala (1966 p. 55-56, 61) the full compensation shall cover the objective value (market value) of the expropriated property, the depreciation of the value of the retaining property (severance), and other damages and costs which will weaken the financial situation of the expropriated owner:

¹ Similarly in Sweden (Expropriation Act 2:12 §; Kalbro 2001 p. 14).

² In the Constitution of the United States it is stated that private property shall not be taken for public use without just compensation. Expropriation is there called eminent domain. (Denyer-Green 1998 p. 8-9)

³ In Finland the compensation is not generally based on the replacement costs of the property (Korhonen 1997 p. 28; Hollo 1984 p. 220-221). However, in the Government Bill on Expropriation for Defence Purposes (224/1996) the principle has been clearly expressed

$$TC = (V + S + D) + C,$$

where

TC = total compensation

V = compensation for the expropriated property

S = compensation for severance

D = compensation for damages

C = compensation for costs.

The parentheses are used to show the elements, which, because of assessment methodology normally lead to a higher value than the owner's total loss, and which in that case are to be corrected to get the full compensation (Wiiala 1966 p. 62). The compensation for the property (V + S) can also be calculated as a difference of the value of the property before and after the expropriation, e.g. the Finnish Act on Expropriation (43 §).

The formation of the total compensation is expressed differently in different countries. According to Denyer-Green (1998 p. 256, 279) the compensation sum can be stated:

1. Compensation for land acquired
 - (a) Value of land ... +
 - (b) Disturbance... +
2. Compensation for damage due to injurious affection or severance (if any) +
3. Additional payments.

This can be expressed in a formula: $TC = 1(a) + 1(b) + 2 + 3.$

In principle no bigger differences can be seen in these formulas. The total compensation sum will in practice depend on detailed provisions in legislation and on the assessment procedure used.

The main rule for the assessment of compensation for the property acquired is the market value (e.g. Denyer-Green 1998 p. 175; Kalbro 2001 p. 15). The basic valuation method is the sales comparison method, although also the income method, and in certain situations with no market activities, the cost method may be used. Norell (2001 p. 131 ff.) applies the market simulation method in addition.

In Finland this traditionally means a market value calculated from comparable real property transactions. The compensation for the property will be assessed according to these statistical analyses whenever the number of transactions is high enough for analyses. The use of statistical analyses is feasible because of the Public Real Property Transaction Register kept by the National Land Survey.

However, it may be asked how well does the statistical price determined according to comparable transactions compensate for the losses? Will the compensation statutes, valuation methods and manners really lead to just compensation? And how just will it be if the expropriator gets the whole profit from a property, especially when expropriated by private quarters mainly for private purposes?

In Sweden Werin (1978; 1982) has cast doubts that the use of sales prices may lead to a systematic error when assessing compensations. He starts with the owner's subjective value in a voluntary transaction. The owner is reluctant to sell as long as the offer will not exceed his/her subjective value. This means that the buyer has to pay at least the subjective value of the seller. On the other hand, the buyer does not pay more than his/her own subjective value. This means that the price in the transaction will be between these subjective values. However, at every moment there is only a limited number of owners ready to sell their properties. Most of the owners are using their properties by themselves. The sellers on the market are those owners who no longer see the ownership interesting, for one reason or another. This means that the sales prices will originate from the lowest subjective values and the owner does not get a compensation based on his/her subjective value when the compensation is based on the sales prices in the market. (Kalbro & Sjödin 1993 p.31)

The use of sales approach has aroused discussion even in Finland. In the Government Bill on Expropriation for Defence Purposes (224/1996) it is stated e.g. that the sales approach reveals the range for the local market prices. To get a full compensation the expropriated owner should be able to purchase a similar property in a voluntary transaction in the normal market instead of the expropriated property. This would be realized in expropriations for defence purposes by using a concept of the highest market value, which means within the range of the standard deviation value higher than the mean [$\text{mean} \leq \text{standard deviation} \leq (\text{mean} + \text{standard deviation})$]. Also Lind (1997 p. 18) in Sweden has seen problems with the definition of market value and compensation: "If we define market value in relation to the actual market, one effect might be that market value becomes less relevant ... when compensation should be determined. Suppose that sellers on a specific "thin" market are not very prudent and knowledgeable: The market value is low compared to what it would be if sellers were prudent. If state expropriates a property on such market it might be judged that compensation based on market value would be unfair. Should an owner that might have no interest in selling at the current market price, and have difficulties in finding a comparable object, lose money just because other seller have not acted prudently? ... the legal rules concerning compensation could refer to a *hypothetical* market value – what the market value would be if the parties were prudent and knowledgeable." Further Norell (2001, Abstract, 225-227, 244) suggests that when determining fair compensation for encroachment on agricultural property by roads and railways there may be justification for using a certain margin of safety in relation to an amount estimated by conventional valuation methods.⁴

3. PROFIT-SHARING IN EXPROPRIATION

In Sweden a change in the Real Property Formation Act in 1993 brought new elements to determining compensation. According to the Act an area of land from one property unit can be transferred to another by reallocation. On certain conditions reallocation can be undertaken against property owners' wishes. In practice, the procedure is often employed as an alternative to compulsory purchase. In many cases the procedure primarily concerns relations between individual persons, e.g. in plot formation for the purpose of creating or enlarging

⁴ Norell's calculations were mainly based on income approach.

properties intended for building development⁵ (not called expropriation). In cases of this kind the “seller” is to be compensated for the reduction of market value. But in addition “reasonable allowance” shall also be made for the value of the land to the “buyer”. The Act states that the compensation should correspond to the price that could have been expected if it had been a normal voluntary transaction. (Kalbro 2001 p. 18-19)

This means that the provisions in the Swedish Real Property Formation Act are based on a different compensation principle than in the Expropriation Act. “The compulsory purchase generates a profit and this profit somehow has to be apportioned between buyer and seller. In other words, the compensation paid to the seller must correspond to compensation for the injury and to a share of the profit which the measure implies. This rule of compensation, then, is more favourable to the seller, the reason being that in “private compulsory purchase” it has not been considered fair to favour the buyer in the same way as happens under the Expropriation Act.” (Kalbro 2001 s. 21)

Although this sounds rather strange at once and the implementation may face some difficulties a closer look shows that the idea is rather familiar. In fact the idea to assess the compensation on the bases of sales approach is to simulate the bargaining in a voluntary transaction. The profit-sharing can also be illustrated with an example from a special case.

Let us suppose that there is a special price, 100, for a collector who presents a full series of collection cards by a certain date. Just before the time limit A is missing one card, which B happens to have, although B has not been an active collector. It is not obvious that A can get the missing card from someone else than B. The separate card has in practice no value but the full series still has. What would be the price when both A and B are aware of the situation? Will B give the card worthless to him/herself free to A, will B claim a share of the profit according to the number of the cards (i.e. 1/100), or half of the profit, or 99/100, or even the whole 100, because the value of card is 100 for A? It is rather obvious that B would get some share of the profit if they reached an agreement. At least children seem to share their ”profits” according to the number of participants.

Suppose that A had a right to purchase the missing card from B by compulsion it would seem rather unfair if B did not get any compensation of the profit that A would get. Probably the majority of people would feel that unfair. If B got a compensation based on the price of the raw material used for the card, e.g. 1, he/she would probably not be satisfied with the compensation. This would perhaps lead B to destroy the card and everybody would be unhappy. Hopefully our methods to assess the compensation are more fair.

The profit-sharing in ”private compulsory purchase” is neither unfamiliar in Finland. For example in shore areas in Finland the land is rising up and the shore owners are entitled to compulsory purchase of this alluvial land. The value of the area is normally very low to the owner of the alluvial land but it may be rather high to the shore owner, e.g. if the area enlarges a building plot. In practice it is accepted that the “seller” shall have a share of the ”buyer’s” profit. This has been accepted also by courts. According to Tenkanen (1983 s. 273) the ”seller” gets about 30-50% of the value of the enlarged plot on the average. Even other cases in profit-sharing can be found in Finland (e.g. Viitanen 1999).

⁵ Rather similar compulsory purchase procedure is used also in Finland.

4. CONCLUSION

Only a few aspects of expropriation and compensation are treated in this article. Expropriation is an old procedure, which is needed in societies with private ownership and market economy. Expropriation bases on full compensation. The assessment of compensation is, however, rather complicated and full compensation may not always be reached. In some cases the legislator has even considered it necessary to reduce the compensation. Nowadays public organizations are outsourcing their activities and many services are produced by private enterprises. In some cases it can be questioned if it is fair with private expropriator to compromise the full compensation. It can even be justifiable to give a share of the expropriator's profit to the owner as seen above.

The most important fact, however, is that the expropriation and compensation can be handled smoothly and in a fair way. It is more important than a "right" price according to the statistics. By this way also the process costs may be reduced (e.g. Ekbäck 1995) and all parties can be satisfied.

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