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Uncertainty of Valuation in Expropriation Processes - the Case of Poland

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Abstract: *In Poland and in many other countries, different laws allow expropriation of property from their owners for public purposes. In such cases, the dispossessed persons must be recompensed for the value of the yielded property to ensure that the total value of assets they held is not diminished. The compensation is calculated using the market value of a specific asset. According to the Polish Legislature, the compensation amount can be established by means of the replacement value only in situations when the market value cannot be found. The article discusses the market value as the compensation basis in expropriation processes and seeks to demonstrate that the value does not ensure just compensation. In an expropriation situation, compensation should exceed the market value that attempts to objectify the market. The valuation figure should take into account the special situation of the expropriated person. The article concentrates on solutions provided in the Polish legislation.*

Keywords: *expropriation, compensation, market value, uncertainty of valuation.*

1 Introduction

In the post-war history of Poland, the institution of expropriation has evolved substantially. Before 1989, expropriation of real property was one of the basic instruments used by the authorities to restructure country's economic system. The instrument was used quite often for two reasons, i.e. the broad range of purposes legitimizing expropriations and the rule of non-equivalent compensation for the expropriated property. This form of state's

intervention was frequently abused and the expropriated properties were put to uses other than those indicated in the expropriation decisions.

In the transition years, guarantees were created that the ownership rights would be protected. They also considerably reduced the possibility of expropriation. An important legal act was the principle introduced by the Polish Constitution of 2 April 1997 that the Republic of Poland should protect ownership and inheritance rights, and that expropriation would only be allowed for public purposes. A public purpose must fit within the definition of public interest. Depriving one private entity of its real estate to endow another private entity cannot be deemed an act in public interest.

The notion of public purpose has been given a statutory definition. Their types include undertakings within the competence of the Treasury or units of the territorial self-government. For instance, the list of public purposes includes marking off land for public roads, the construction and maintenance of public water utilities, the construction and maintenance of the environmental protection facilities and of water reservoirs, the protection of real estate of cultural value, the establishment and maintenance of cemeteries. The catalogue of public purposes is an open-end document – the Legislature decided that other purposes provided in separate statutes would also be treated as public purposes.

According to the law, expropriation is only justified when: the restriction or deprivation of owner's right to a real property is the only way to fulfil public purposes. A title to real property cannot be acquired on a contractual basis. The following titles are subject to expropriation: an ownership right, a perpetual usufruct right, other restricted titles to real property (such as the right to use a property, personal easement or easement appurtenant, or a special right of housing cooperative's member to a residential unit, commercial unit or a single-family house).

Expropriation can only concern real properties marked for public purpose in the local zoning plan. A public purpose overrides the right of ownership. Ownership is not an absolute personal right that serves exclusively the owner's interest and excludes other persons. Sometimes a real property must be taken over to make public purposes attainable. When a transaction cannot be concluded by means of a voluntary civil law contract, expropriation makes it possible for the authorities to purchase a piece of property using a negotiated civil law contract or via an administrative decision. The regard to social justice makes the determination of compensation an important challenge.

2 Compensation for expropriated property in Polish law

The already mentioned Polish Constitution of 2 April 1997 resolves that expropriation should only be allowed when it serves a public purpose and when just compensation follows. Just compensation should be understood as compensation that makes up for the value of the expropriated property.

The Parliament has defined rules underlying the calculation of compensation in the real estate act. Two factors influence its amount: the condition of a real property on the expropriation day and the property's value on the day when the compensation decision is issued. The expropriated property is recompensed with money or in kind, if the dispossessed party agrees to accept an alternative property.

The compensation amount is based on a market value provided by a property valuer. When the market value cannot be found, then the replacement value is used. To find the market value the comparative and income approaches are employed and the replacement value is calculated using the cost approach. Polish valuation rules follow the British school of valuation.

The market value of a real property takes into account its present use, unless the new use related to the purpose of expropriation increases the property's value. If this is the case, the alternative use must be applied to find the market value. In other words, the seller receives compensation that makes up for the incurred loss, but also reflects expropriator's benefits.

3 The concept of just compensation

Although in the legislation of many countries (also in Poland) the main principle applying to the payable amount of compensation states that the owner's material status must remain unchanged, individual countries implement it differently. In some states (e.g. Sweden), compensation is calculated against the market value for the present use; others, such as the UK, apply the best and highest use (Viitanen, 2002). While regulations applying to compensations tend to enable former owners to exchange the compensation for a comparable property, strict rules allowing them to attain this goal do not exist (*ibidem*).

Wiil formulated an undoubtedly correct concept that the full amount of compensation should reflect the objective value, i.e. the market value of the expropriated property, but also the diminished value of the remaining property (broken ties, division), and other losses and costs that adversely affect the expropriated owner's financial status (after Viitanen). The item "other losses" includes also the feeling of being wronged (Viitanen). Polish legislation rejects this approach, as it concentrates on valuing the material loss. A loss is incurred, when the value of person's assets goes down because of dispossession, destruction, damage or a reduced value of property components, or when liabilities expand because new debts appear or the existing ones grow larger. Drawing up rules stating how compensation should be determined, the Legislature omitted the notion of lost benefits, i.e. those that an expropriated party could attain, if it kept all its assets (Filipiak, 2006).

This approach is contrary to the Constitution and civil law. In Article 77, the Polish Constitution states that every person is entitled to compensation for the incurred damage. The Parliament has decided that:

- whoever is guilty of causing damage to another person is obligated to make the damage good (art. 415 of the Civil Code)
- A legal person is obligated to make good damage caused by its organ (art. 416. of the Civil Code).

4 Market value as the basis of loss valuation in polish circumstances

Valuation for expropriation purposes is not frequently commissioned. In Warsaw, a city with a population of two million, there are approximately 200 valuations of this type requested every year. In the Polish legal system, the market value makes the point of reference for seeking the amount of compensation. It is only when the market value is not available, that the replacement value is applied.

The market value definition as used in Poland corresponds to the international definition provided in the International Valuation Standards. A market value is understood as the most probable price that one can obtain for an asset on the valuation date, assuming that the parties to the transaction are independent of each other and determined to conclude it, aware of the factors that affect the value, willing and not forced, and that the traded asset has been exposed on the market for sale for a sufficient time. In order to find the market value the market must be analysed and atypical data derived from irregular transactions that do not meet market requirements must be rejected. Valuation of any asset invariably involves some subjective elements. Therefore, an attempt at valuation is burdened by uncertainty and gives rise to risk. When the valued object is a real property, the amount of uncertainty is unusually high. It stems from the very characteristics of real estate and the level of market maturity in a given country. The latter is combination of the functioning legal system, the level of market transparency, valuers' qualifications, and customers' pressure on valuation figures. The uncertainty of property valuation is higher in less mature markets. Therefore, the scale of uncertainty in the emerging markets seems to be larger.

The real property market in Poland is a case of a typical emerging market characterised by

- Weak legal system that does not allow the real property market to function efficiently. As illustrations proving the lack of comprehensive solutions in Poland, the unreformed land and mortgage register system (making an entry in the register takes several months) and the unavailability of local zoning plans can be indicated;
- The unavailability of reliable information that is necessary to make a dependable valuation. Data disclosed in the notary deeds do not always indicate the price that was actually paid for a real property and additionally they do not provide a good description of the traded property;

- Strong volatility. This characteristic of the real property market is due to Poland's entry to the European Union and to substantial flows of capital, including speculative capital;
- The insufficient education of property valuers. Although valuers are required to hold the government licence to be able to make valuations, their theoretical knowledge and practical skills are frequently deficient.

The above discussion demonstrates that the market value treated as the basis for calculating compensation for expropriation and other purposes is exposed to substantial uncertainty. Polish research confirms that the uncertainty of valuation is substantial and that inadequate education of property valuers is its important source (Kucharska, 2005). Notwithstanding the efforts to objectify the market circumstances, the valuation figure is a personal estimation of a hypothetical price, an expert's opinion (French and Gabrielli, 2003). The less competent the expert, the less transparent and more volatile the market, the higher uncertainty.

Besides, the degree of uncertainty depends on the unique characteristics of a real property. Properties that are more complex need larger numbers of variables to be valued, which consequently contributes to higher uncertainty of valuation figures. Other reasons for which property's market value cannot be recognized as a good basis for identifying the loss incurred by the expropriated party are:

- The value does not reflect market conditions on the valuation date, because a valuer uses historical data obtained from concluded transactions. In the Polish practice, only market data derived from notary deeds are recognized as useful for valuation. In a growing market, the market value will be underestimated and in a contracting market its overestimation can be expected.

- The market value is based on prices under the assumption that the market is effective (in other words, the prices are expected to reflect market changes fast and completely). However, the effectiveness of the real property market is low – new trends are not reflected in either the rented space prices or investment property prices. The reasons are the low transparency of the market, the confidentiality of transactions, as well as rules applying to rental agreements and to the valorisation of rents.

The character of the market value suggests that it is a hypothetical price as of the valuation date, which is the date of fulfilling the valuation purpose. For the analysed case, it is the date when the competent authority issues the expropriation decision. Compensation is payable as a single amount within 14 days following the day on which the expropriation decision became binding. The Legislature has provided an option allowing to valorise compensation, should the purchasing power of money dropped in relation to other goods between the establishment of the compensation amount in the expropriation document and its payment date. The valorisation mechanism is based on the Consumer Price Index published by

the President of the Central Statistical Office. However, the CPI does not take into account changes in the real property market. The indicated value is therefore a hypothetical price determined on the valuation date and not the actual price for which the expropriated owner might purchase a comparable property. Some possible causes of variations between a new property price and a value underpinning the amount of compensation can be:

- ◇ changes occurring in the real property market between the valuation date and the compensation payment date,
- ◇ Changes taking place in the real property market between the compensation payment date and the day on which a new property is purchased.

Considerable differences between the purchase price of a comparable property and the amount of compensation (understood as a hypothetical price) appear in strongly volatile markets. The emerging markets show particularly dynamic changes. The scale of the changes is illustrated by data showing variations in average prices paid for single-family houses in the secondary market and in flat prices paid in the primary market in the capital cities of Poland's regions (charts 1 and 2).

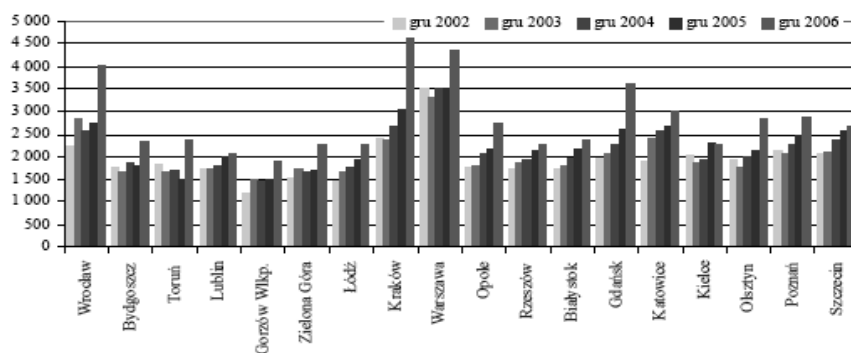


Figure 1. Average prices of single-family houses in the secondary market by regional capital (PLN/sq m), years 2002-2006. Source: PKO BP

Departament Rynku Mieszkaniowego, developed by Lechosław Nykiel

* gru = December

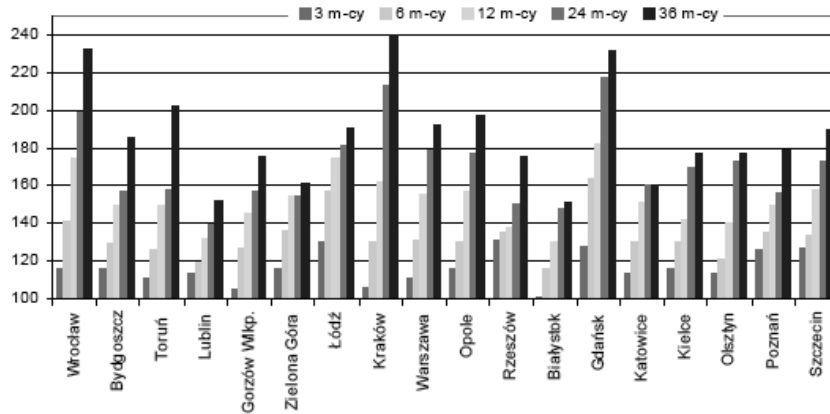


Figure 2. Increases in flat prices in the primary market in regional capitals over the last 3, 6, 12, 24, 36 months (previous period =100). Source: PKO BP Departament Rynku Mieszkaniowego, developed by Lechosław Nykiel
* m-cy = months

From the above it follows that the market value cannot be recognised as a correct basis for calculating a loss incurred by the expropriated party, because of:

- the uncertainty of valuation,
- The nature of the market value, which is a hypothetical price on the valuation date and not on the date when the expropriated owner purchases a real property.

5 Practical examples

Example 1

An expropriation proceeding aimed to take over a property on which a bridge in Warsaw was to be constructed. A single-family house was built on the property that was not attractive either in terms of its design, the state of repair or functionality. The owner showed all rooms to the valuer, including the utility room. Finally, he asked the valuer whether he noticed that the owner was blind. The valuer did not see that. The house was specially designed and adapted to a blind person's needs. The long years in which the owner lived in the house made it possible for him to learn its layout and move freely. To function well in another house, the expropriated person would have to participate in the designing process.

A market value reflecting market circumstances, the technical and functionality standards does not offer compensation allowing the expropriated person to buy a comparable property, because such a property may not exist.

Example 2

An expropriation proceeding aims to acquire a property to construct a motorway. The owner is a disabled person moving on a wheelchair. The house has been renovated and adapted to its owner's needs. The house is very nice. The owner can function because of the neighbours' assistance that do shopping for him and help run this single-person household. The expropriation will destroy the neighbourly ties and deteriorate owner's quality of life.

Example 3

An expropriation proceeding aims to create an urban public space as a result of a revitalization process. The property to be expropriated has several uses; a house and a car service station are built on it. The combination of the residential and commercial functions allows the owner to provide services round-the-clock. The location is very advantageous for the type of business that has been run there for 15 years and has many steady customers. Expropriation will disrupt the business activity, break ties with the customers, and make the owner seek new place for living and working.

Example 4

An expropriation proceeding aims to take over some piece of land to construct a road. A larger portion of the land is strongly undulated and the part subject to expropriation is flat, so the owner will keep land with inferior parameters. The owner planned to develop a surface parking on the plot. Its reduced size and the lie of the land prevent his project from being implemented. Such terrain only allows the construction of an underground parking facility, but the change of plans would involve disproportionately high costs.

Valuation rules used in Poland to calculate the amount of compensation concentrate on valuing the loss. This article seeks to demonstrate that the market value cannot be taken as a good basis for identifying the loss. The full compensation should considerably exceed the market value, as the latter does not always provide good market objectivization, and does not ensure just compensation either, because it ignores:

- costs needed to find and purchase a new property,
- owner's expenses connected with the removal and arrangement of the new property,
- benefits due to owned property's adaptation to occupant's specific needs,
- severed interpersonal and professional ties,
- Diminished value of the retained part of a property.

Therefore, the market value does not guarantee just compensation (as the Legislature terms it). Polish laws applying to the calculation of

compensation for an expropriated property are contradictory to the country's Constitution.

6 In search of an alternative solution

Because the market value is not a good basis for calculating just compensation, the fundamental question arises, what the basis should be.

The question is essentially theoretical, because the legal framework in Poland does not allow payment of compensation in excess of asset's market value, which fact has been additionally stressed in a decision made by the Supreme Chamber of Control (a national audit office).

The market value should only be indicative of the lower limit of compensation. In addition to the market value that objectifies the market, another value should be stated, describing the upper range of prices that can be found in the real property market. Such calculated basis should be enlarged by adding at least the costs of seeking a new property suiting the expropriated owner's needs together with individually appraised lost benefits, while taking into account the situation of the expropriated person. This approach certainly makes the valuation process more complicated, but it aims at ensuring just compensation.

Final comments

The Polish law allows expropriation for public purposes only and for just compensation. Just compensation should enable the expropriated owner to acquire a comparable real property, but also to make up for the lost benefits and even for the feeling of being wronged. The existing Polish regulations only deal with recompensing for the actual loss. Valuation figures are burdened by uncertainty and so the compensation amount may not be sufficient to cover the value of the expropriated asset. Since compensation reflects neither the actual loss nor the lost benefits, it cannot be deemed just.

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