

'Margin of error' in property valuations – is there a need for safety margins in compulsory acquisitions?

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- The ownership of real property is protected by the constitution in most countries.
- However, in most cases the “public” has reserved a right to limit the constitutional protection of property when it is necessary for the public good.
 - *For example, if the society needs a land area of a real property for a street, the owner has to convey land for that purpose, if not voluntary then by compulsory means.*
 - *For this interference there are normally strict preconditions.*
- This article focuses on the precondition that is perhaps the most significant one in relation to the protection of property: the requirement of full compensation.



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- FIG recommendations (2010): the compensation shall ensure that the affected party's financial position is not weakened in the process of compulsory purchase.
 - *Full compensation shall (at least) ensure that those displaced are able to re-establish their lives and livelihoods in a proper manner (Viitanen et al. 2010a, p. 5).*
- In the FIG recommendations market value is stated to be the basis of value for the assessment of compensation (Viitanen et al. 2010b, p. 30).
 - *European Court of Human Rights (Pincová and Pinc v. the Czech Republic, no. 36548, judgment of 5 November 2002, final on 5 February 2003):*



Compensations shall be based on market values

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- By the definition market value can be understood as the most probable price for a certain asset (IVS 2014).
 - *Market value is not a fact but rather an opinion.*
- The outcome of a valuation is only certain if the valuer can accurately predict the future. Given that is not possible, there will always be an element of risk that the realized price differs from the predicted estimate. (French and Gabrielli 2004.)



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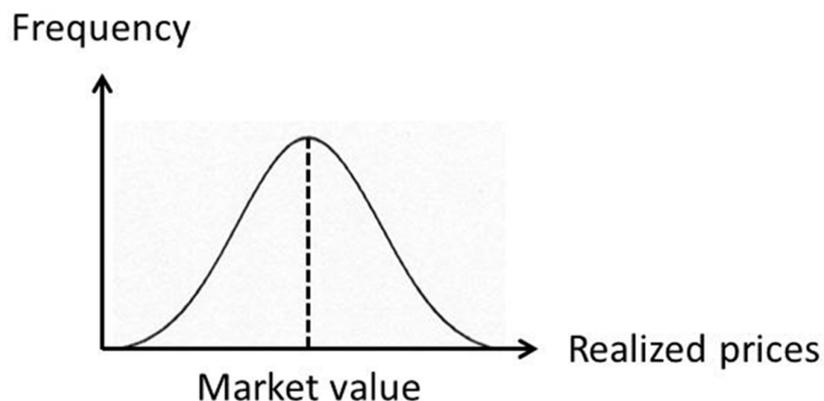
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- When the transaction actually realizes the price paid should be in 50 % of the cases lower and in 50 % of the cases higher than the market value.



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- This means that if the basis of value is market value the compensation received by the conveyors is in 50 % of the cases too low to acquire an equivalent property.
- This seems to justify use of a certain margin of safety. This is the question that will be discussed in this article.

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- The purpose of this study is to evaluate the variation in property valuations and to conclude whether or not there is a need for safety margins.

- **Literature review**

Materials: Peer-reviewed articles

- What are the things that contribute to inaccuracy?
- How big is the 'margin of error' in property valuations?

- **Questionnaire**

Materials: 440 authorized/certified property valuers

- The variation in property valuations was estimated by giving the same valuation task to different property valuers.
- After each valuer had given his/her opinion about the market value of the property, standard statistical methods were applied to analyze the results.



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Literature review (1/2):

- Property valuations contain both random and systematic errors. Factors identified as contributing significantly to inaccuracy in real property valuation include:
 - *the nature and state of the property market (Millington 1985, Bowles et al. 2001, Dunse et al. 2010),*
 - *quantity and quality of data (Dunse et al. 2010, French and Gabrielli 2004),*
 - *definition of value (Millington 1985, Baum and Crosby 1988, p. 5),*
 - *the integrity of valuer (Levy and Schuck 1999),*
 - *complexity of the property (Bretten and Wyatt 2002),*
 - *valuation methodology (Baum and Crosby 1988, p. 20),*
 - *skill, experience, and judgment of valuer (Gallimore 1998) and*
 - *clients' influence (Levy and Schuck 1999, Amidu and Aluko 2007).*



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Literature review (2/2):

- Apartments, condominiums etc
 - 95 percent stayed within 15 percent variation (Daniels 1984; Rossini 1999)
- Commercial properties
 - 80 percent stayed within 20 percent variation (Blundell & Ward 1997); 65 percent stayed within 10 percent variation (Hutschinson et al 1996).
- Detached houses:
 - 70 percent stayed within 20 percent variation; 30 percent stayed within 10 percent variation (Matysiak & Wang 1995)



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Questionnaire:

- In Finland, the margin of error seems to be really high.
 - The median value for the valued farm property was 305.000 euros. The minimum estimate was 195,000 euros and the maximum estimate was 650,000 euros.
 - 80 % of the valuations stayed within – 28 % and + 60 % from the median valuation; 50 % of the valuations stayed within – 16 % and + 33 % from the median valuation.
- The big variation may indicate that the valuers just did not familiarize themselves enough to the property market involved because this was an exercise and not a valuation task from a real client.



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- If the basis of value in compensations is market value, the object compulsory acquired is compensated according to its market value. If the market value estimate is too low, so is the compensation.
- The problem is that we can never know if the market value is too low or not because it cannot be observed
 - *prices can be observed but market values not*



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- It is undeniable that a compensation based on market value is not a guarantee that it will be possible to purchase an equivalent property as replacement for a compulsory acquired unit.
 - *It is easy to understand why the market value is in many cases too low for a property owner to feel to have been fully compensated, and half are by definition entitled to feel so!*
- Based on the observations made in this research it seems just to employ some sort of safety margin or additional compensation. It cannot be fair that the assignor party who unwillingly participates the project behind the compulsory acquisition bears the risk of uncertainty in valuations.
 - *An explicit answer on the scale of the safety margin cannot be given based on the observation made in this study.*



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- We argue that every market value estimate is correct if it is done according to standardized methods because market value is “only” an opinion.
- It is more important that a valuer follows an appropriate methodology rather than that the resulting valuation is “accurate”.
- Why should valuers alone among other professionals be judged by the result. Doctors do not always cure the patient, lawyers do not always win the case, but still they are judged by the way in which the task was done rather than what was the outcome.



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Thank you for your attention!

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