

# Compulsory Acquisition of Land - Compensation for Development Values<sup>1</sup>

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## SUMMARY

A basic idea behind rules of compensation is, in many countries, for the party forced to surrender land to be in the same economic position as if the compulsory acquisition had never happened. The property owner shall be compensated for the damage he suffers.

The compensation normally corresponds to the *market value* of the property. When only a part of the property is affected by compulsory acquisition, the compensation must equal the loss of market value. However, there may be exceptions to the principle of compensation corresponding to the market value. One exception, in some countries, is that values based on expectations of a change in land use – *development values* – are not compensated, i.e. the compensation shall be based in the value of existing land use.

The purpose of this paper is to discuss whether development values should be compensated or not from the perspective of “fairness”.

<sup>1</sup> The paper is based on Kalbro (2003).

# Compulsory Acquisition of Land - Compensation for Development Values<sup>2</sup>

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## 1. INTRODUCTION

Compulsory acquisition (expropriation) of land is controversial in many respects. When is such an acquisition legitimate, i.e. when is the “public interest” requirement fulfilled? It has been argued that compensation corresponding to the market value will, not, necessarily, give property owners “full compensation”.<sup>3</sup> In some cases, when the compulsory acquisition is made for commercial purposes, e.g. telecommunication lines, compensation as “profit-sharing” between buyer and seller has been discussed.<sup>4</sup>

Two years ago the Swedish Government gave the “Inquiry on Compensation for Expropriation” the task of determining whether there is reason to change the rules of compensation laid down in the Swedish Expropriation Act (1972:719). The Inquiry is to consider, among other things, whether compensation should be paid for development values, i.e. values based on “expectations” that a permission to change the land use will be granted. In this case the market value is higher than the value of existing land use. The Inquiry is due to present its conclusions in the end of 2008, so there is still some time to discuss the matter.

## 2. PRINCIPLES OF COMPENSATION IN THE SWEDISH LEGISLATION

A basic idea behind the rules of compensation is for the party forced to surrender land to be in the same economic position as if the compulsory purchase had never happened. The property owner shall be compensated for the damage he suffers, and in this sense compensation can be said to be based on a principle of indemnification. The main rule is for the compensation to correspond to the *market value* of the property, i.e. the price which it would fetch in the open market. When only part of the property is affected by compulsory purchase, the compensation must equal the *loss* of market value which the compulsory purchase entails. If this compensation does not fully cover the economic injury to the property owner, compensation shall also be paid for what is termed *other damage*. Compensation for “other damage” may come into question, for example, when a property owner has to move house or close down a business conducted on the property.

However, one exception to the principle of compensation corresponding to the market value concerns values based on *expectations* of a change in land use, i.e. development values (chapter 4, section 3, the Expropriation Act).<sup>5</sup> In the paper, this legal provision will be labelled the “DEVELOPMENT VALUE RULE”.

<sup>2</sup> The paper is based on Kalbro (2003).

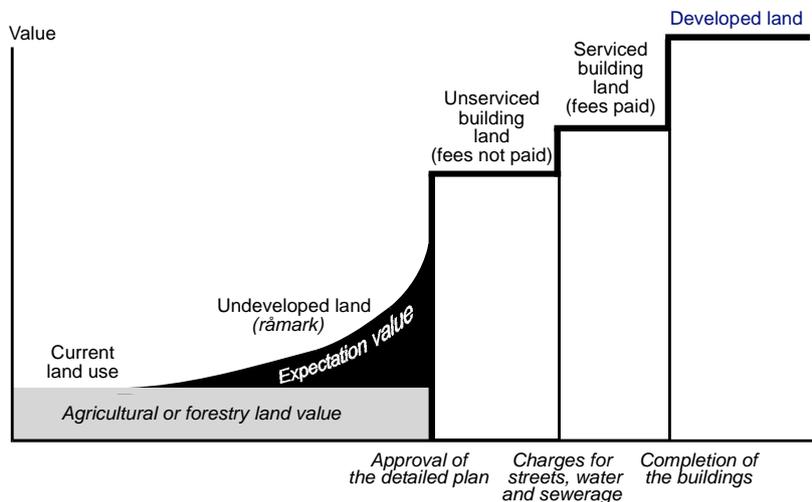
<sup>3</sup> See e.g. Werin (1978) and Miceli & Segerson (1999).

<sup>4</sup> See e.g. Kalbro (2007).

<sup>5</sup> Another exception is that effects of the compulsory acquisition as such on the market value of the property are to be disregarded, Chapter 4, section 2 in the Expropriation Act.

**Section 3.** In determining purchase money, an increase of any importance in the market value of the property unit occurring from the day ten years before the expropriation application, though not more than fifteen years before the filing of proceedings with a court of law, shall be credited to the owner only insofar as it is established that the increase is due to other things than expectations concerning a change in the permitted use of the land.

From a Swedish perspective the figure below provides a schematic model of the development of values and prices during the development process.



Before notions of a change in land use are born, the value of *current or existing land use* to properties is determined. This can refer to agricultural and forestry land or land which has already been built on. When changes in land use come to be expected, “*expectation values*” occur. Land not included in a legally binding detailed plan but affected by expectations of a change in land use is referred to in Sweden as undeveloped land (*råmark*, literally “raw land”). In certain cases, expectation values can develop on the strength of more or less uncertain assessments of future development. In other cases they may be triggered by municipal declarations about development, combined with the preparation of a comprehensive plan.

In connection with the detailed plan being adopted and becoming legally binding, complete certainty is established concerning the permissibility and nature of the development. The land is then “upgraded” from undeveloped land to undeveloped building land (*råtomtmark*). This elimination of the final traces of uncertainty concerning land use brings an instantaneous rise in value. Apart from the value of undeveloped building land, the period following the adoption of the detailed plan includes another two phases or value levels. In order for plots in the plan to be built on, charges have to be paid for streets, water and sewerage installations, property subdivision etc. When this has been done, a value of “buildable” building land (*tomtmark*) accrues. The third value level refers to the developed plot, i.e. after building permission has been obtained and the building development on the plot completed. This final value level, of course, is “primary” in a development project and therefore governs the value movement occurring in earlier phases of the development process.

And to the heart of the matter: the exception to the market value principle says that *expectation/development values need not be compensated for* if they accrued after a certain point in time

### 3. WHAT IS A REASONABLE AND FAIR COMPENSATION?

Compensation for development values can be analysed from, at least, two angles. Firstly, development values can be related to so-called "unearned increment". Secondly, the compensation issue relates to a general principle of justice, namely "equal treatment" of individuals.

#### 3.1 Compensation for unearned increment?

Unearned increment can be defined as "an increase in the value of land, or property, without expenditure of any kind on the part of the proprietor". Increase in urban land value, *not* as a result of property owner investments, can be divided into three major groups.

1. Planning and permission to change the land use.
2. Public investments in roads, water & and sewage, schools etc.
3. General economic development due to technological achievements, population increase, changes in interest rates etc.

The DEVELOPMENT VALUE RULE in the Swedish Expropriation Act was basically legitimated with category 1 and 2 above, i.e. measures and investments made by public bodies.<sup>6</sup> The rule though, as formulated, is more far-reaching than that. Also land value increase due to general economic development will be uncompensated when the rule applies. Furthermore, the development value provision is also applicable when the acquirer is a private body, e.g. an electricity or a telecommunication company. In these instances the relationship between development values and investments by the companies is very much questionable

However, if one accepts the concept of "unearned increment" it may be reasonable and fair that compulsory purchase compensation does *not* include development values. But the story does not end here. As will be seen in the next part there are other considerations that have to be made.

#### 3.2 Equal treatment of property owners?

A central principle of justice is that equal individuals are to be treated equally and different individuals are to be treated differently. The principal is formal in that it cannot decide when individuals are to be deemed equal. It tells us that, if we want to be just, we must consistently act by predefined rules, but it does not tell us which material rules are just. The principle, then, has to be supplemented by criteria which distinguish between relevant and irrelevant differences between individuals.

<sup>6</sup> Bill to the Parliament 1971:122.

Here the problem of equal treatment will be discussed from the following situation: There are two adjacent properties of similar size and land use. For the two properties there are expectations of a changed, and more efficient, land use, i.e. the market value of the properties contains development value. We then assume that *one* of the properties is acquired by compulsory means. Thus the question is: what are the effects of the DEVELOPMENT VALUE RULE from an equal treatment point of view?

The effects will be described in two cases. In the first case we assume that the land use – after the compulsory acquisition – will fulfil the expectations and realise the development value on the property. The second case shows the opposite situation, i.e. the acquisition “destroys” development values.

### 3.2.1 Case1. ”Realisation” of development values.

When expectations for changed land use are rational and based on relevant information development values will be realised, i.e. a planning/building permission will lead an increase in the market value that is equal, or higher, than the pre-permission value. When the property owner implements the new land use, the value increase accrues to him/her.

In Sweden municipal compulsory acquisition may, under certain conditions, take place for “urban purposes”.<sup>7</sup> The DEVELOPMENT VALUE RULE enables the municipality to acquire the property at the value of existing land use. In the next phase the municipality conveys the property to a private developer at a price corresponding to the market value.<sup>8</sup> Through this “broker role” the municipality will make a profit (the difference between the market value and the compensation), whereas the property owner will be compensated for the loss of current land use.

The effect of the development value rule in this case is *unequal treatment*. The property owner who has to surrender his land is treated worse compared to his neighbour, who benefits from land value increase when a new, more profitable land use is permitted.

### 3.2.2 Case 2 “Destruction” of development values.

In Case 1 the aim of the compulsory acquisition was to implement new development and create higher (market) values. In many cases, however, we face quite the opposite situation. The compulsory acquisition is carried out in order to implement e.g. conservation/recreation areas and roads. In this case the market value of the property is completely wiped out (and thereby also any development values). The effects of the DEVELOPMENT VALUE RULE in this case can be illustrated with the two following scenarios.

<sup>7</sup> Ch. 2. sect.1. the Expropriation Act. If e.g. the property, or property owner, structure prohibits new development which is in the “public interest”.

<sup>8</sup> The municipality is not allowed to sell the land at a price that is lower than the market value. See EU Commission (2003).

(1) In connection to compulsory acquisition of one of the properties the municipality's strategic "master plan" is altered for the neighbouring property. Through the plan alteration future expectations of changed land use are dashed, and the property owner is not entitled to any compensation due to the planning decision. In this case the two property owners are treated equally. The property owner who has to surrender land is compensated with the value of existing land use. The neighbour keeps his land with a value decided by the existing use. Thus *both* property owners "lose" the development value.

(2) One property is compulsorily acquired in order to develop the neighbouring property. This may be necessary if the new development (with e.g. housing) requires green areas, schools etc. preferably is located to the first property. In this case it is obvious that the properties are unequally treated

### 3.2.3 Comments

It is not without its problems to discuss "equal treatment" of property owners due to difficulties to distinguish between similar and dissimilar situations. However, in the two cases above the outcomes of the DEVELOPMENT VALUE RULE are not unambiguous. In some situations the DEVELOPMENT VALUE RULE will lead to unequal treatment, in other cases the rule is a prerequisite for equal treatment!

## **4. CONCLUDING REMARKS**

When the DEVELOPMENT VALUE RULE was introduced in the 1970s the main motive was to avoid compensation for value increase "created" by public planning and investments. As mentioned the rule is more far-reaching than that, by not compensating land value increase due to general economic development. Since the rule also is applicable when e.g. private electricity or telecommunication companies acquire land, it has re-distributional effects that hardly was intended (40 years ago when the acquirer, almost without exception, was a state or municipal body).

To what extent the DEVELOPMENT VALUE RULE treats property owners "equally" has been described in the paper in two typical cases. In one of the cases – when a municipality acquires land (to the value of existing use) and later sell it (to market price) to a private developer – the rule may be regarded as "unfair". Or can it be legitimized that municipalities are given the opportunity to make a profit of the acquisition in order to e.g. investment in public infrastructure?

This paper is, to some extent, critical to the DEVELOPMENT VALUE RULE. However, the rule must be seen in its historical context. Land development for housing in the 1970s (until the beginning of the 1990s) was subsidized by the State through loans and grants. A condition for receiving these loans/grants was that the costs, land included, selling prices and rent levels did not exceed a certain limit. In this system the cost of land played an important role, i.e. the

lower costs the lower prices/rents for housing. Consequently the DEVELOPMENT VALUE RULE was a mean to keep the costs for land at a low level (below the market value).

Today the State subsidy system with cost and price regulation has been removed. Now housing developers operate under “pure” market conditions. This fundamentally changed situation has underlined criticism against the DEVELOPMENT VALUE RULE. Therefore it will be interesting to see if the Government’s “Inquiry on Compensation for Expropriation” comes to the conclusion that the rules must be altered, or perhaps completely abolished.

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