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REAL PROPERTY VALUATION IN EXPROPRIATION IN ETHIOPIA; BASES, APPROACHES AND PROCEDURES

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ABSTRACT

The purpose of this study is to examine the existing real property valuation practice for expropriation in Ethiopia and to suggest potential bases and approaches compatible to the Ethiopian real property market system. The study is grounded on desk review research in which existing literature is the main source. The study found that, there is no standard and responsible institution for real property valuation. Due to this valuation variation and inaccuracy is common. The study suggests market value can be a potential base as it reflects the actual value of the property expropriated. Moreover, market and income approaches can be the potential approaches to Ethiopian setting. But discretion should be given to the valuer to choose the appropriate approach. The study recommends the establishment of independent institution responsible for overall valuation activities including establishing standards and introducing valuation certification by considering the real property market system of Ethiopia.

Keywords :

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1. INTRODUCTION

Land is a key resource and a driver of economic growth particularly in countries like Ethiopia in which wealth depends predominantly on land (USAID, 2007). So, its administration and governance influence wellbeing of societies. According to, Lindner (2014) Ethiopian land administration face rent seeking, speculation and corruption problems. This is driven by absence of clear land policies, strong institutions, transparency and public participation in the system. There is no single document which deals with land policy instead, laws and policies must be inferred from federal laws, together with laws and directives set by regional and municipal governments. Confusion of laws is also another problem facing the system. In Ethiopia formal expropriation as a means of land acquisition is introduced in 1908 when the land charter of Addis Ababa city was enacted(Ambaye, 2013). The scale and size of expropriation has been increasing through time. Currently it is a predominant land acquisition method and practiced when government at any level believes it necessary in the name of public purpose.

Real property valuation is an important activity in expropriation since right holders should get compensation based on the estimated value of the lost property. In the preceding laws including the Addis Ababa land charter and the civil code, real property valuation issues were not clearly addressed. However, the current federal expropriation proclamation under Art.7(2) stipulates replacement cost approach as a method of valuation for all types properties (FDRE, 2005). Since expropriation is a forced sale, then the compensation must enable the loser to go to the market and fetch similar property of comparative utility. But the expropriation law denies this fact under Art. 7(1) by claiming land is not compensable element (FDRE, 2005).

In Ethiopia there is no valuation standard, as a result real property valuation has been practiced without any framework based on intuitive knowledge by a committee. This contradicts the international valuation practice where certified valuers do the valuation assignment depending on the national or international standards (RICS, 2017a). As a result, the valuation output may not consistent and appropriate. Moreover, there is no strong national institution that gives clear policy as well as technical and financial guidance for real property valuation. As a result, valuation standards, which cover ethics, and competency issues like the basis of valuation, the stated purpose of the valuation and competency tests of the valuer are absent. This leads to the application of non-standardized valuation rates and techniques in different areas of the country. Lack of using standardized methods means unfair compensation of right holders which is against the constitution.

Although a number of reforms in different sectors in the past years in Ethiopia, real property valuation issues have continued to raise unresolved methodological questions. Particularly, there is no any policy for real property valuation in the country at any level. Thus, arbitrary property valuation practices are common, which may have a long run negative impact on tenure security of right holders. Therefore, there is a need of property valuation standard stating the general bases and compatible to the property market system and also in line with internationally accepted practices. This study is therefore based on the following two research questions. First, how real property valuation is exercised in case of expropriation? and second, what are the existing real property valuation bases and approaches functional for expropriation purpose? Based on the findings, appropriate bases and approaches of real property valuation for expropriation which is compatible to Ethiopian property market setting is suggested.

The paper is organized in five parts. Section 2 deals with method of the study. Section 3 is devoted for the existing literature on real property valuation bases and approaches. Section 4 is dedicated for the results and discussion which focuses on the existing real property valuation practices in Ethiopia and the potential bases and approaches. Section 5 concludes the result and put policy implications.

2. METHODOLOGY OF THE STUDY

This study is based on desk review research in which the researcher basically involved in collecting data from existing resources. It is predominantly relied on secondary data i.e. it is mainly based on the information collected through review of the available documents relevant to real property valuation. Secondary data was collected from valuation legislations, annual reports, books, journal articles, magazines and relevant documents. The data were organized, analyzed, and interpreted using narrative analysis and thematic categorization.

3. LITERATURE REVIEW

3.1 Real Property Valuation

Real property valuation is an art and a science of determining the most probable price of an interest or right in property encompassed in an ownership for a particular purpose at a particular point in time (French, 2003). The concern in real property valuation is to estimate the property interests which can be defined by state or the law of individual jurisdictions and are often regulated by legislation. It is widely used in financial and other markets to assist private or public institutions decision making in the process of financial reporting, taxation, compulsory acquisition, purchasing and selling, loan security or other statutory purposes (TEGoVA, 2016, Adair et al., 2003, IVSC, 2017).

Today it is a common activity in many countries even if the bases, approaches and methods of valuation for particular decision may vary based on countries culture and experience (Pagourtzi et al., 2018). Although the characteristics of properties is widely varied, the Appraisal_Institute (2013) suggests all valuation problems can be solved through the systematic application of the valuation procedure. In this regard, the IVSC, suggests eight-step procedure which includes definition of problem, site inspection and market studies, data collection, selection and analysis, choice of appropriate valuation basis and method/s, reconciliation of values indicated and arriving at the final opinion of value and reporting of the defined value (Babawale, 2013).

3.2 Bases of Real Property Valuation

A basis of value is not a valuation approach or method adopted but it is a statement of the fundamental assumptions for assessing a valuation for a defined purpose (RICS, 2017a, TEGoVA, 2016, IVSC, 2013). Bases of value describe the fundamental assumptions on which the reported values will be based which includes issues like the nature of the hypothetical transaction, the relationship and motivation of the parties, the extent to which the asset is exposed to the market, and the unit of account for the valuation

(IVSC, 2016). The most commonly used bases of valuation in the valuation literature are market value, mortgage lending value/MLV/, investment value/IV/, synergistic value, fair value and special value.

Market value is the most common and widely accepted bases of value for a wide range of purposes. It describes an exchange between parties that are unconnected and operating freely in the market place, and ignores any price distortions (RICS, 2008). It does not show an assessment of value over the longer term but only at the time of the hypothetical transaction TEGoVA (2016). It excludes the additional costs that may be associated with sale or purchase as well as any taxation on the transaction. It is internationally recognized and has a long-established definition. *IVSC (2017) defined it*[1]*as the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion*. Similarly, fair value measures the estimated amount like market value but the parties in fair value may be unconnected and negotiating at arm's length, the asset is not necessarily exposed in the wider market and the price agreed may be one that reflects the specific advantages or disadvantages of ownership to the parties involved rather than the market at large (TEGoVA, 2016). Market value is the appropriate base of valuation for expropriation (Parker, 2016). In many countries, even additional replacement costs to the market value to the compensation is considered (Tanrivermis and Aliefendioglu, 2017). But, TEGoVA (2016) argues there are circumstances where alternative bases may be required or may be appropriate. It is particularly true in cases of bubble-tendencies and cyclical movements in property markets and stock markets.

With regard to MLV, although it is not acknowledged as a basis of value in the IVS, it is applied in the TGoEVA and RICS valuation standards in UK and EU (RICS, 2018, TEGoVA, 2016). It is based on sustainability, avoidance of any speculation, traceability, standardization and marketability (Bienert and Brunauer, 2007). It is used by credit institutions for collateral valuation purpose. This is because it is a value-at-risk approach to manage the risk exposure of them taking into account special safety requirements(TEGoVA, 2016). MLV is likely, in most market conditions, to be below MV but offers a guide to expected underlying long-term trends in the market (Anop, 2015). But may be indistinguishable from MV in stable markets.

Investment value, is mostly important to measure the performance of an asset against an owner's own investment criteria (RICS, 2017a). It is the maximum price that a known individual bidder would offer according to his specific investment requirements but not measure the overall judgement of the market on the property (TEGoVA, 2016). Although MV, IV, MLV and Fair Value are the common bases of valuation for different purposes, there are also other bases of value including equitable value, synergistic value, liquidation value, and special value where they can be applied in certain circumstances[2].

[1] The detailed conceptual explanation of market value can be inferred from IVSC 2017. International Valuation Standards. London, United Kinkdom IVSC.

[2] For detail explanation of the basis of value please referrer ibid.

3.3 Real Property Valuation Approaches

3.3.1 Introduction

Although there are certain differences in application and greater differences in nomenclature, there are three principal approaches to real property valuation: the market approach, the income approach and the cost approach (TEGoVA, 2016). The theoretical bases of these approaches is dated back to 1920 when Alfred Marshall combined the supply-cost theory with demand-price theory as a basis of value (Moore, 2014). The three approaches are not mutually exclusive, with the use of more than one approach for cross-verification is encouraged, particularly where valuation inputs are limited (Parker, 2016). In cases where the valuer has high degree of confidence in the accuracy and reliability of a single method, they are not required to use more than one approach of valuation (IVSC, 2017). But, using more than one valuation approach is a normal practice, or even a legal obligation for some valuation purposes in some instances, which depends on property type and available information (Schulz, 2003). It is especially recommended where there are insufficient factual or observable inputs for a single approach to produce a reliable conclusion (IVSC, 2017). For instance, in Belgium each property type needs to be valued by two most appropriate approaches and checked or controlled by at least one other approach (Adair et al., 2003). When more than one valuation approach is employed, the valuers has to make a final reconciliation step to derive a final estimate of the market value(Schulz, 2003).

The adoption of the three approaches for a particular property being valued depends on the appropriate basis of value, premises of value, purposes of valuation assignment, appropriateness of each approach in view of the nature of the asset, the market condition and the availability of reliable information needed to apply the approach (Aro-Gordon, 2015, IVSC, 2017). But valuers are responsible to choose the approach/es that, in their opinion, are the most appropriate to the property being valued unless there is legislation or statute applicable (TEGoVA, 2016).

3.3.2 The Three Approaches Compared

The market approach is the most widely used and accepted approach to determine value in real estate valuation practice for various purposes. It is based on the theory of value which says value of the real estate is based upon the views of the typical buyer and seller of the property, independent of cost, to create or wear and tear(Miller and Geltner, 2004) and founded on the principle of price equilibrium(IVSC, 2017). As it is based in comparison, in market approach the level of similarity between the subject asset and those assets recently transacted is of fundamental importance, as property interests are not homogenous (IVSC, 2017). When the valuer judgement is applied consistently, the market approach is both logical and rational, leading to an assessment of value that is transparently supported (Parker, 2016).

The income approach, on the other hand, involves estimating the market value by assessing the income that the property is expected to generate, then discounting the income stream to arrive at the present value (Pagourtzi et al., 2018). It is based on the economic principle of anticipation of benefits (IVSC, 2017) and the value theory which assumes that the value of the property is based upon the typical investor 's yield requirements, current financing possibilities, and the property risks (Miller and Geltner, 2004). It is appropriate in cases where yields can be established easily as in the case of office markets where more evidence of rental transactions exist (TEGoVA, 2016).

The cost approach has rooted its source from the classical school of thought at the time of Adam Smith (Jaffe and Lusht, 2003). It considers solely from the supply side of economics equating cost with value without considering the crucially important demand element. The underlying value theory for it is the value of the property is inherent in the cost to create the property based on land acquisition and building costless wear and tear and depreciation (Miller and Geltner, 2004). It is an approach based on the economic principle of substitution stating that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility whether by purchase or by construction, unless undue time, inconvenience, risk or other factors are involved (IVSC, 2017). However, the application of this principle in the context of property is much more challenging, exacerbated by the type of property for which the approach is considered (Parker, 2016). It is particularly more problematic given that construction of buildings needs time and that land for building purposes might not be immediately available, prices and costs will diverge in the short-run (Schulz, 2003). Moreover, the true worth of an asset will not be the same as its cost but a function of the expected benefits or cash flows derivable from that property.

Since cost approach is not market driven, it should not be looked on as a primary approach in estimating the value of the property. However, it can be used when there is either no evidence of transaction prices for similar property or no identifiable actual or notional income stream that would accrue to the owner of the relevant interest (IVSC, 2017).

In many European countries including Finland, France, Norway, Sweden and the UK, the cost approach is used only for specialized properties where there is no transaction evidence and where there is no useful or relevant evidence of recent sales transactions due to the specialized nature of the asset (RICS, 2017b, Adair et al., 2003). In other European countries like Germany, Switzerland, Spain, Norway, Belgium and Portugal, it is more widely used, usually in tandem with other approaches, the exchange value being a weighted average of the two outcomes (Adair et al., 2003). In these countries when the end result of a valuation is weighted almost entirely towards the outcome of a comparative approach, the cost-based figure is retained as a check (Adair et al., 2003).

4. RESULT AND DISCUSSION

4.1 Conceptualizing Real Property

Real property considers all rights, interests and benefits related to the ownership of real estate. It is a right of ownership, control, use or occupation of real estate (Parker, 2016). Whereas, real estate is the physical part including all things that are a natural part of the land (trees, minerals) and things that have been attached to the land (buildings and site improvements) and all permanent building attachments, mechanical and electrical plant providing services to a building, that are both below and above the ground (IVSC, 2013). Although real property is the most common nomenclature in various nations, in the Ethiopian laws it is understood as an immovable property. The sources of these laws are the civil code. The civil code under Article 1130 categorizes land and buildings under immovables (EmpireofEthiopia, 1960). Although real property includes land and all permanent improvements to land as explained, in this study it is referring land and buildings in urban areas excluding special purpose properties like heritages, churches, mosques, etc.

4.2 Traditional Real Property Valuation Practice

Real property valuation practice is strictly tied to usage and customs related to the economic activity of different countries and therefore arises from and is developed in national contexts in relation to legislative, administrative and fiscal regulations and in general to the economic and social situation (Adair et al., 2003). Literatures are scant about the Ethiopian traditional valuation practice but there are indications that some sort of market and cost approaches were dominant. In earlier times, elders were responsible for valuation in case of transfer particularly sale. They considered the input materials, orientation, accessibility of basic services, recent sales of similar properties, etc. By including their indigenous knowledge, they fix the price. Mostly, both parties satisfied with the estimated price.

4.3 Real Property Valuation in Ethiopia

In Ethiopia, although the practice of real property valuation had long history, it has been practicing without national standard. Today valuation for expropriation is ruled by the expropriation law. The expropriation proclamation under Art. 7 (1) stipulates that a landholder whose holding has been expropriated shall be entitled to payment of compensation for his property situated on the, land and for permanent improvements he made to such land (FDRE, 2005). This contradicts the very essence of market value by ignoring the economic value of land.

The expropriation proclamation under article 7(2) states that the amount of compensation to expropriated shall be replacement cost approach for all property types (FDRE, 2005). The justification given can be inferred from the constitution under article 40(8), which states compensation is given only for the private property where private property is any tangible or intangible product which has value and is produced by the labor, creativity, enterprise or capital of an individual citizen as defined in the constitution under article 40(2) (FDRE, 1995).

However, the amount of compensation which is basically based on the valuation, varies across time, regions and source of finance for compensation(Alemu, 2013). Applying this approach for all types of the properties is problematic. This is because cost of replacing the improvements is not equivalent to the worth of the property. As a result, land is being excluded from the compensation package and hence it has no value for the holder. Moreover, location value of the property is denied in expropriation although land holders can collect it during sale. The denial of compensation for the value of the land is contradictory to Art. 40(3) of the constitution itself that recognizes the joint ownership of land (FDRE, 1995).

According to the replacement cost method similarly constructed buildings located in different parts of a city or among the cities are getting the same amount of compensation. However, practically similar houses in different areas get different amount of compensation. This means in the valuation location may be considered in some arbitrarily way. Although the replacement cost approach is the least preferred in obtaining the market value, in some cases it can be used particularly if it is impossible to apply other methods. However, in Ethiopia its application is in defective way in that the value of land or location advantage is not considered(Ambaye, 2013).

In Ethiopia as stated in the expropriation proclamation under article 9, the valuation of property situated on land to be expropriated shall be carried out by certified private or public institutions or individual consultants on the basis of valuation formula adopted at the national level. But until the required skill ascertained, it will have to be executed by committee members of relevant field (FDRE, 2005). However, there is no any initiative by the government to introduce certified valuers even after 15 years of the law is enacted. For committee members it is a tough task to estimate the market value of the property in the dynamic property market. I believe, the estimated value obtained through this arbitrary process definitely results inadequate compensation. The Ethiopian practice is also against to the practice in many countries. For instance, in Brazil, Engineers and Architectures with valuation specialization, in UK and US real estate degree holders, in China construction, economics, business and finance experts with valuation specialization are responsible for valuation (Adair et al., 2014). Although the expropriation law under Art. 9(1) says the existence of single valuation rate adopted at the national level, in practice different valuation rates has been applied. Alemu (2013) and Deininger et al. (2012) support this argument by showing the existence of intra-and inter-regionally valuation rates depending on the engaged institutions, committees established, and the source of finance.

4.4 Potential Bases and Approaches of Valuation

4.4.1 Introduction

Since there is contextual differences among nations, the choice of specific valuation bases, approaches, techniques and standards may vary (Adair et al., 2003). However, Parker (2016) argued standards of property valuations in various countries have to harmonize with each other, and to do that there must be a strong, single benchmark of common standards to which states can relate. In this regard IVSC put some common bases of property valuation while leaving scope for flexibility in methodology and application to suit differing countries and differing circumstances (IVSC, 2017). In Ethiopia there is no national valuation standard in which bases approaches and techniques of valuation is taken. In the preceding sections the potential bases, approaches and techniques of real property valuation for Ethiopian real property market system is discussed.

4.4.2 Bases of Real Property Valuation

Bases of value is important in dictating valuation approaches, inputs and assumptions applied in valuation estimation. Although the economic value of land is denied in the constitution and other subsequent laws, in actual market transactions, it is the land which has significant contribution to the total worth of the property. The sale price of small houses in the center of large cities are inflated due to location. In this case, it is the land which is actually transacted rather than the improvements. Therefore, the government should use the market value as a base of real property valuation as it is actually practiced in the ground. In line with this argument McAuslan (1987) suggests actual practice recognition in the policy is the key determinant of policy triumph.

Moreover, the law recognizes leasehold right where the basic rights of usus, fructus and abuses is possible for urban dwellers (FDRE, 2011). So, compensation of these rights is possible through market value as it indicates the actual worth of the property as of the valuation date. Compensation which is not consider the rights mean affecting the human rights of lease holders. Because land rights are part of human rights as it relates right to adequate housing, right to adequate food, right to adequate standard of living, etc. as discussed by Mekuria (2010).

4.4.3 Approaches of Real Property Valuation

For the proposed base of value, market and income approaches can be used alternatively based on the nature of properties and availability of data about the subject property. For residential purpose buildings market approach is appropriate since it is possible to find comparable in the market. In Ethiopia in sales transaction the market approach is used by buyers and sellers of real property where brokers have a significant role in price and rent determination. Although brokers practice a general tendency of inflating prices, with an overall intention of benefiting mostly from the commission calculated as percentage of the sales/rent value of each transaction, they have the tendency of using market approach. This is an indicator of the application of market approach in actual transactions between economic units. For commercial and industrial purpose properties income approach is appropriate since it is possible to predict annual income and expenses. Cost replacement approach could be used as an alternative when access to market data is impossible in all cases. But the application of this approach should be by considering the economic value of land.

Normally in real property valuation, more than one approach is recommended (Adair et al., 2014). In this regard, the Ethiopian government my give discretion to valuers to apply either two of the three methods and then through reconciliation the market value can be obtained. Another alternative may be also possible in that government may give chance to the expropriated people to come with their own value estimates by employing certified valuers and then compare the value estimate with government value estimates. Then, the final value can be considered by some arithmetic weight method or average.

5. CONCLUSION AND POLICY IMPLICATIONS

5.1 Conclusion

In Ethiopia, there is no clear real property valuation policy and responsible institution for it. Besides, there is no certified valuers for doing the valuation assignment. As a result, valuation activities have been practicing arbitrarily by a committee without proper bases and approaches with cumbersome procedures. This adversely affects the amount of compensation and right loser's livelihood at large. Variations and inaccuracies in valuation is also common due to non-standardized valuation systems. Although laws and legislations in Ethiopia denied the economic value of land, in actual land dealings in the market it has significant contribution. Therefore, the market value of the properties can be considered as a potential valuation base since it is practically there. The market and income approaches of valuation are also compatible to the proposed base of value. So, they can be considered the predominant approach, but the cost approach can be used as an alternative approach when data is insufficient in the market. In any case the specific choice of the approach and technique of valuation is left for the judgement of responsible valuer with in the given legal frame work.

5.2 Policy Implications

Real property valuation can be realized by creating a specialized institution. Such institution would be most effective if supported by legislative provision which is compatible to the practical conditions at the ground. Government should also develop property valuation standards by taking the traditional valuation practice and the international valuation standard as an input. But the developed system of property valuation should be based on market values and has to include capacity building for implementation. In particular, this should include training on property valuation: basic for government officials and more advanced for the private sector real estate professionals. Moreover, high ethical standards, independence and professionalism in valuation practice should be encouraged through training and through encouraging the establishment of professional valuation associations. In doing so, the level of valuation variation among actors can be reduced and the level of valuation consistency can be improved.

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8. KEY TERMS AND DEFINITIONS

Real Property Valuation is an art and a science of determining the most probable price of an interest or right in property encompassed in an ownership for a particular purpose at a particular point in time

Valuation Base describes the fundamental assumptions on which the reported values will be based which includes the nature of the hypothetical transaction, the relationship and motivation of the parties, the extent to which the asset is exposed to the market, and the unit of account for the valuation

Valuation Approaches are ways in which a valuer deals with the whole matter of valuing the subject property.

Expropriation is the right of the nation or state, or of those to whom the power has been lawfully delegated, to take private property for public use, and to appropriate the ownership and possession of such property without the owner's consent on paying the owner a due compensation to be ascertained according to law.