

Module VII

Economic Issues in Risks Management: The Economics of Valuation and Eminent Domain

Introductory Note

Part III of the training course consists of two tightly interconnected lectures/modules. Having explored in the prior sessions the basic “building blocks” of the IRR model, it is appropriate to consider now some of the key economic, financial, and legal issues that are surfacing with increasing acuity from both practice and scientific research, shining light on how the resettlement risks can be better managed in practice.

The knowledge on development-induced resettlement is evolving rapidly, fueled by the continuous search to find practicable, effective solutions to the adversities that forced displacement imposes on people. Failures have been frequent, and they too make imperative the crafting and adoption of alternative approaches. The consensus is growing that it is necessary to significantly reform many of the currently accepted principles, methods, and norms in resettlement, taking into account feedback from practice. Changes are needed not only in practice, but also in mind-sets: in fact, the former cannot happen without the latter.

In this spirit, sessions VII and VIII of this course discuss several key issues that are currently under exploration and re-examination in various countries. These include some innovative approaches and challenging ideas, based on the feedback and information flowing in from research and project practice. On some of these, “the jury is still out,” and further testing is necessary.

Module VII examines in particular key aspects of valuation procedures in resettlement, and of eminent domain law application and interpretation. Lecture VIII will take these issues further, focusing first upon the compensation principle and then on other financial aspects in resettlement. These are the need for supplemental financing in finance to invest in the reconstruction of resettlers’ economic foundations and the need to legislate benefit-sharing mechanisms to channel part of project-benefits to resettlers. Such investment financing is instrumental for achieving “resettlement with development.”

Public sector projects rely on the legal principle of eminent domain for carrying out condemnation and expropriation of lands and assets. However, the eminent domain principle requires also that a correct valuation of the condemned assets be carried out and that “just

compensation” be paid. It turns out, however, that valuation methods often are too crude. Even when replacement costs are taken into account, very often the estimated values are not reflective of the real losses incurred by those displaced.

Furthermore, when valuation itself is done only by the party that decides upon expropriation and has the power to enforce it—that is, by the state—the resulting valuations are often highly biased downward. The democratic procedures that require valuations to be done by a third party, which would be a neutral party, or with the participation of those expropriated, are rarely, if ever, implemented.

Difficulties appearing in resettlement practice demonstrate that it is necessary to improve the currently applied methods for valuation and the calculations of replacement costs, first from a technical economic viewpoint, but also in terms of considering who should do the valuation. Existing eminent domain regulations leave sufficient room for involving neutral specialists for carrying out such valuations. But is this “room” utilized? This is a question to be explored collectively during this training session.

Further, the estimated values need to be subject to consultations and negotiations between the project that requires “right of way” and the people who lose their lands and houses. Adequate grievance avenues for situations in which agreement is not achieved must remain open at all times. In this respect, the lecture signals also recent research in economics that attempts to refine valuation techniques by proposing a shift from valuation based on “willingness to pay” (WTP) to valuation based on “willingness to accept” (WTA). The trainer has a good opportunity to explain how responsible management of resettlement risks can create a conducive environment for correct valuation, acceptable also to those being expropriated.

Because the different methods with which asset valuation is carried out result in different levels of compensation, it is essential to improve these methods in all possible ways in order to ensure fair compensation and prevent project cost externalization on the resettlers. Improved valuation and enhanced compensation increase the ability of resettlers to rebuild their lost assets and economic basis.

Another important issue discussed in this lecture is about the applicability of the eminent domain principle to projects in the private sector. Laws and practices differ considerably from one country to the other. This suggests that there is room for change: where existing legal procedures and practices have not yielded satisfactory results, both the laws and the entrenched practices can be and must be changed.

For instance, in most countries, the eminent domain principle can be legally applied—for expropriations entailing displacements—only in the case of public sector projects. In such cases, private lands are expropriated to become publicly owned and publicly used lands.

In private sector projects, which by definition are “for profit” projects, land acquisition is to be carried out as a market transaction between the private project and the owners of the land. The market process to be followed for acquisition under such projects is valuation and purchase through a “willing buyer-willing buyer transaction.”

In some countries, however, the application of the eminent domain law has been extended to private sector projects (which are by definition “for profit” projects)

rather than being applied only in “publicly owned” or “public use” projects. This extension eliminates the role of the market and replaces it with the administrative force of the state to impose expropriation, instead of allowing valuation through “willing buyer-willing seller transaction.” This shift exposes resettlers to new or increased risks of de-capitalization, as their prior capacity to negotiate prices with a private entrepreneur is taken away by the state. What would have been otherwise a free market transaction becomes now subject to the coercion involved in state-led expropriation. The welfare of the displaced and resettled people suffers. In order to prevent the resulting impoverishment processes, changes in legal provision may become indispensable.

The discussion of the dysfunctions and risks intrinsic in biased valuations will be continued in the subsequent lecture (VIII) devoted to improving compensation practices. Financing the reestablishment of those displaced and de-capitalized by enhanced compensation supplemented by development investments and by sharing of project benefits will be shown in the next lecture as a practical necessity.

Lecture VII

Economic Issues in Resettlement Risks Management

Valuation for Compensation and Eminent Domain Procedures

Lecture VII: Main Themes

- Since the basic objectives in resettlement are economic (income and livelihood improvement), the basic tools for achieving them should be also economic and financial.
- The economic analysis for Resettlement Action Plans (RAP) must confront specific issues, distinct from the general project economic analysis
- Main economic issues in DFDR are:
 - ⇒ the losses caused by displacement and expropriation;
 - ⇒ valuation of losses;
 - ⇒ avoidance of cost externalization;
 - ⇒ restitution through compensation (calculation, delivery, etc.);
 - ⇒ investments to supplement compensation; and
 - ⇒ benefit-sharing with resettlers.
- Eminent Domain legal principle: justification and limitations
- Eminent Domain in public sector.
- Does Eminent Domain apply also to private sector projects?

Lecture VII: Main Themes (continued)

- The economics of dispossession and loss through expropriation
- The importance of correct property and assets inventories
- Differences in the valuation of tangible assets, of lost opportunities, and of intangible goods and values
- Valuation procedures and measurements may distort outcomes
- Participation of the displaced in valuation and negotiations
- How can valuation methods be made more accurate?

From Valuation to Compensation

[The discussion of valuation will continue in the next lecture (VIII), related to compensation, investments, and benefit sharing for economic recovery]

Preview of main themes in next session:

- Compensation as instrument for resettlers' re-capitalization:
Does it live-up to its function?
- Typical distortions in compensation procedures
- Structural limits of compensation as main resource for improving livelihoods
- Distinction between “compensation and investment.” What are the investments in current resettlement components?
- Financial resources are needed for reaching the level of “Resettlement with Development”
- Benefit-sharing as financial source for sound resettlement

The “Economic” and the “Social” in Reconstruction

- Economic restoration and improvements are the core and the premise for broader social reconstruction.
- Recurrent failures and impoverishment are prompting an intense search for novel solutions, new instruments.
- Innovative approaches and good practices emerge here and there: need to identify, analyze, replicate, and generalize them.
- What is our basic success criterion in resettlement projects?
The policy objectives
- Consistency and discrepancies between policy-mandated goals and policy-mandated means in resettlement. Are means commensurate with policy goals?
- How to overcome internal inconsistencies and overcome risks?

The Need for Specialized Economic Analysis of DFDR

- The specific nature of forced displacement, expropriation, and resettlement raises unusual economic issues, different than mainstream project activities.
- Therefore DFDR requires a distinct economic and financial analysis, and a commensurate budget. Such economic analysis and budget are a basis for the Resettlement Action Plan (RAP).
- This special analysis must include
 - ⇒ valuation of losses incurred by the displaced population,
 - ⇒ assessment of replacement costs,
 - ⇒ calculation of compensation,
 - ⇒ necessary investments for all other reconstruction costs, and
 - ⇒ budgeting.
- In practice, however, although resettlement is structured as a distinct “project component,” or a “project within a project,” it is often not subjected either to full-scale economic and financial analysis, or to a specially adjusted “component-economic analysis.”
- Many RAPs lack a distinct economic analysis and budget, and are weakened by this absence.

The Need for Specialized Economic Analysis of DFDR (continued)

- Most frequently missing is the economic analysis of reconstructing resettlers productive basis at the new relocation site. This leaves the resettlement budget under-financed.
- Project CBA (Cost-Benefit Analysis) is applied to the project at large for justifying the investment. But CBA, by definition, is insensitive to cost and benefit distribution, among the project stakeholders.
- Topic for discussion: why is it important to analyze distribution, and determine who stands to gain and who stands to lose from a given project?
- Cost externalization: What is it? How does it occur? Why is it unacceptable in development projects?
- Conclusion: Under current international guidelines, resettlement operations do not receive the scrutiny of a full battery of analytical economic techniques.

Eminent Domain as Legal Dispossession: Justification and Limitations

- Eminent domain (ED) issues, and opposition to ED, are surfacing in all countries (developing and developed) concerning the extent of ED applicability and its effects on those affected.
- Examples:
 - ⇒ India: The revised Land Acquisition Act (1994) expands eminent domain use to private sector project
 - ⇒ USA: Supreme Court 2005 Decision on New London Case, Connecticut, USA and the new national controversy ignited across the USA limiting ED to public sector situations
- Legal justification of eminent domain: the state pursues the “highest good for the largest number.”
- In-built limits in ED law, in public sector: imposes expropriation without mandating resettlement, providing only compensation. ED laws do not have explicit provisions for resettling those displaced, thus are behind currently accepted international standards.

Risks and Financial Losses Resulting from Eminent Domain Extension

- Practices and trends in some countries (e.g., India), to expand application of ED law for land acquisition by the state on behalf of private sector projects.
- ED is supposed in its original definition to be invoked for “public use” state (public sector) projects.
- Private sector projects (some co-financed by IFIs, including ADB) also need land for footprint, but land acquisition in private sector projects (“for profit”) has historically developed well-tested market rules for free negotiation of acceptable prices.

The “Willing Buyer-Willing Seller” Norm

- The norm of “willing buyer-willing seller” (WB-WS) has less risks and gives higher protection to small landowners than Eminent Domain law by avoiding: (i) expropriation, (ii) one-sided valuation, and (iii) low compensation. It allows monitoring of transactions.
- India’s Land Acquisition Act (1994) replaces “willing buying-willing seller” market principle by extending ED law from “publicly owned and used” projects to “public interest,” a vague criterion. Critics argue that “public interest” is a very loose and soft justification, conflicting with constitutional guarantees for security of property.
- The private sector ability to acquire land by using the ED (power of the state) exposes resettlers to new and increased risks of de-capitalization. They lose the right to bargain directly with private companies.
- Market-based purchase and incentives can secure land for private sector projects, while also better protecting the interests of small landowners. Isolated “holdout” cases can be solved without prejudice.

Eminent Domain and New Financial Losses

- Empirical evidence from RETA country studies found:
 - ⇒ Growing extent of land acquisition through ED expropriation for transfer of private property from small private owners to other (large) private owners.
Is this a legitimate role of the state?
 - ⇒ A significant difference exists between the low “paid price” by the state (as compensation to those displaced) and the high “transfer price” (the price received by state from private companies).
- The difference between “paid prices” and “transfer prices” represents the amount of financial extraction from what is due to landowners, a “measure” of one form of cost externalization and impoverishing of displaced people.

Eminent Domain and the “Holdout” Cases

- Some justification for using (ED) state power may exist in special “holdout” situations, at the limit. This is when isolated individuals or small groups keep “hostage” projects, while the bulk of acquisition cases is resolved through “willing buyer-wiling seller” (WB-WS) arrangements.
- WB-WS usually generate much higher prices for condemned land and immobile assets than ED forced acquisition.
- WB-WS may come close, if done fairly, to changing forced resettlement into voluntary resettlement. Affected people may be interested in trading off their “location” for other significant livelihood advantages elsewhere.

Correctable Deficiencies in Valuation of Lost Assets

- Valuation of lost assets is one of the crucial activities preceding displacement, decisive for fair compensation.
- Asymmetric information between expropriators and displaced people disadvantages the displaced, who need full information, transparency and participation.
- People often resist because of low valuations and unfair price. This often ends up costlier in the long run to developers than paying upfront a fair price to the “willing seller.”
- Material assets must be valued at replacement costs, not at market value. Discuss and explain why the market value of houses is insufficient for replacement and why depreciation should be covered by the project expropriating agent.

Eliminating Bias in Valuation

Valuation is a dual process: technical and social

- The technical part of valuation consists in inventorying fully all assets to be lost (their quantity and their quality) and assembling information on prices. The inventories should be subject to verification and inspection by resettlers' groups/organizations.
- Socially, the conflict of interests involved in valuation must be recognized and biases need to be eliminated. If the expropriator (the state) is also the party which decides on prices, the risk is that the assessed values will be kept low.
- Social and democratic guarantees for fair valuation are higher when a neutral party makes valuations, or is involved in negotiations and monitoring. The displaced groups must be given voice in the application and negotiation of technical measures for valuation.

Innovations in Valuation Methodology

- Recent research in economics has compared two valuation modalities of environmental goods: willingness to pay (WTP) and willingness to accept (WTA). Experiments concluded that WTA levels tend to be higher than WTP levels, but under fair criteria the gap becomes easier negotiable.
- Researchers are now exploring if the same argument can be developed for the valuation of assets lost in population displacement. Economist **David Pearce**, founder of environmental economics, is

“advancing the argument that the correct measure of economic loss from dislocation is one based on WTA, not WTP. We surmise that the use of WTA will provide significantly larger values because of the lack of substitutionability of new locations for the existing ones.” (in vol. Economics of Involuntary Resettlement, 2004).

- This is a new researchable hypothesis, of great promise for practice, if validated.

