Land prices are not simply a matter of Supply and Demand

by Bryan Kavanagh

Fortunately, the theory of real estate valuation is not as difficult to comprehend as the theory of value, over which economists continue to fight endlessly.

Real estate valuation concerns the assessment of particular parcels' market price. It is not about some abstract or philosophical theory of value. Maybe to save confusion though, real estate valuation ought to have been termed 'real estate pricing'.

It is sometimes difficult to price a parcel of real estate where little sales evidence exists, but there are ways of overcoming this by establishing its net rental relative to surrounding properties and capitalising this at a rate reflected by current market conditions.

Capitalising the current market rental is the essence of the theory of valuation. Sir William Petty used it to assess Britain's land and capital stock at 250 million pounds (15 million pounds annual income capitalised at 6%) one hundred and fifty years before David Ricardo 'discovered' the Law of Rent.

Neoclassical economists and some real estate valuers ('appraisers' in the US) claim there are 'positive economics' and theory-of-value implications which make the theory of real estate valuation uncertain. They are correct in one sense only, but the problem is theirs, because they confound land and capital.

We know that money and allotments of company shares have a value, but they are not in themselves created wealth. Nor is land. Theirs are values from obligation or legal arrangements between parties which do not constitute created wealth which is more easily assessed. In the economics sense land is all natural resources: land, sea and air. These are not created wealth, as they are obviously pre-existing.

The difficulties which economists have with the theory of valuation arise because of their confusion of the value of land from legal obligation, to pay a price or some or all of its rent, with the created capital of the improvements which are constructed upon it.

It should be clear that an improved parcel of real estate consists of two distinct parts – the added price of the improvements (the capital works on the site) and the value of the land itself. But what is the price of this 'value by obligation' of the land?

This will depend on whether the land is leasehold or freehold, and how much of its rent remains in private hands. If the land is leased from the Crown at its full market rental, it will have no price. That's correct, little or no price, because the tenant is paying its full market rental for leasehold possession. There remains little or no private rent to be capitalised into a price.

However, if the site is not leased but is in exclusive possession as freehold land, the price of the land will depend upon the quantum of rates and taxes paid annually on the site. These are notionally deducted from the gross rent of the land, and the net rent remaining in the occupier's hands then capitalised, as early conducted by William Petty.

That's the theory, but we will usually have sales of freehold land which allows us to forego all the mathematics of capitalising the land's net market rent in order to assess its price. If there are no sales of vacant land, there will usually be sales of improved land on which the improvements have been demolished, which will allow us to assess the actual price paid for the land by adding net demolition costs to the sale price.

But the significance of what constitutes land price should be understood. It is the private capitalisation of the publicly-generated rent that goes uncaptured on a site, not simply a matter of supply or demand, as for commodities.

So, why then is it always said that high or escalating land prices are simply a function of supply and demand? This may be so to a lesser extent, but the main determinant of the price of land is the quantum of its rent which has not been captured by government in real estate rates or taxes. If the government takes more of the site rent, the land price will be less and, in the case of a leasehold land system where virtually all the land rent is collected, the land price will be close to zero.

It is not well known that there is biblical injunction that land must be held on a leasehold basis:

"The profit of the earth is for all." – Ecclesiastes 5:9

"The land shall not be sold ..." – Leviticus 25:23

But Jew and Christian alike prefer to ignore biblical economics, presumably in order to generate higher land prices, viz, the private capitalisation of uncaptured land rent. For whom is this land price, a pathology in biblical terms, the most profitable? Is it not banks who lend against the security of the combined twosome, namely, the price added by improvements together with the price of the site? It would not appear to benefit those who purchase homes, factories, shops or offices for private or commercial use that land prices are high, but it will certainly assist real estate investors who purchase with the intention of making a profit: "Buy land, they're not making it any more", said Mark Twain ironically.

Nor does it benefit other than 'investors' if land prices are permitted to escalate into unnatural bubbles by taxation privileges granted to investors by way of low municipal rates or land tax, taxation concessions on realised capital gains, or the 'negative gearing' of investment real estate, and so forth.

So, do we have a problem with the land price component in the valuation of real estate? We've learnt that it is not determined merely by supply and demand, but mainly by the extent to which its economic rent (unearned income) is captured for revenue by government. This appears to be novel and unknown to most economists. Therefore, the price of land remains nebulous to those not skilled in land economics. If governments increase the property tax in the US, or rates and land tax in Australia, the land price actually decreases. Should a real estate valuer therefore qualify his/her report to this effect? What if taxation privileges make land an object of investment, rather than of productive use? Is land price indeed pathological? If land prices become inflated into a bubble, such as at present in Australia, surely a valuer must qualify his/her professional report to the effect that if the bubble were to burst, or if real estate taxation privileges were to be withdrawn on capital gains or negative gearing, then the valuation would need to be adjusted lower.

The replacement prices of buildings are known and their depreciation rates may easily be established to assess their added price, because they are of a capital/created wealth nature, but is the price of land–a value by obligation rather than of substantive wealth–a true market price within a real estate bubble?

The valuer must resort to his/her catch-all disclaimer: the 'valuation' is the market price as at TODAY. It cannot be taken to hold true tomorrow, nor at any other time in the future, due to myriad affects on the price of the land component, much of which may disappear overnight.

What particularly is the threat to any assessment produced within a land price bubble? How will banks be affected when that bubble bursts? What is the bank's liability for drawing up mortgages on the 'security' of valuations produced during a bubble, as at present in Australia? If fraud has not been involved in banking's risk management in recent years, negligence most certainly appears to be. The only defence left to bankers is to deny the existence of bubbles – at least until they have burst. [!]

Whilst purchasers of real estate at inflated prices want to see their land prices remain inflated, their children, in their endeavours to buy a home for themselves will be less so-inclined. Although generational discord on the point has grown enormously, it will resolve itself in the eventual collapse of Australian land prices, as is being tentatively seen in all states and territories except New South Wales and Victoria. The media is unsure about land price, so this will be reported as a collapse in 'house' prices.

By conflating land with capital, neoclassical economists remain in the dark about the bifurcation that has grown between economics and the theory of valuation, especially in the light of the land prices bubbles that so repetitively bring world economies to their knees.

Even Tomas Piketty's "Capital in the Twenty-First Century" demonstrates no knowledge of the rent-