

Market Value without a Market: Perspectives from Transaction Cost Theory

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Abstract

The concept of market value is central to the property valuation profession world-wide. While the valuers themselves still remain hugely influential in the market, there is increasing evidence of widespread scepticism about their skills. This article engages with the question why valuers remain important despite the parlous state of their craft. Using insights provided by transaction cost theory, this article argues that market value, as a knowable, determinate and autonomous figure, does not exist because market conditions necessary for its emergence are not found in reality. To account for the continued importance of valuers, the article proposes an alternative theory of market value, one which emphasises its role as a transaction-cost-minimising device.

A valuer spends a year staring in the air and producing a figure at the end which has a magic connotation (Nick Ritblat; quoted in Barrie, 2001).

1. Art, Science or Alchemy: Crisis in Property Valuation Theory and Practice

This article has its roots in a practical problem faced by the author whilst attempting to estimate the market value of a landmark building in the central business district of the Namibian capital, Windhoek. Namibia is a huge country, but is one of the most sparsely populated in the world. Low population

densities coupled with a highly skewed distribution of wealth mean that property markets in general are very thin. The problem at hand, which many valuers will be all too familiar with, was the lack of comparable market transactions on which to anchor the valuation. The problem was particularly acute with this specific property given its uniqueness and the fact that there was no record of market transactions for this or closest substitute properties. By all manner of contrivances, a 'market value' was determined in the end, to the satisfaction of the client. While that marked the end of the matter for the client, the episode set in motion

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a train of introspection on the part of the author. The main issue related to the *meaning* in fundamental terms of the derived market value, a figure that lacked external validation but yet which the client had so readily accepted.

A casual observation of local market practice elicited a few interesting discoveries, of which two are germane to this paper. First, it became apparent that a significant number of parties in the Windhoek property market were transacting on the basis of values appearing in the municipal valuation roll. This was of course not surprising, given the lack of sufficient market evidence, but the problem was that municipal valuation rolls tended to be out of date. This did not seem to deter the market in any significant manner. The second discovery was more specific in nature and was brought to the author's attention by a practising valuer. The valuer was required to estimate the market value of land which hitherto could not be traded as it was held under traditional communal tenure. The land in question had been excised as part of a township development. The valuer admitted, in essence, to conjuring the value in the absence of market evidence. Subsequent to the valuation, however, a market in this land developed, with properties trading at prices mirroring the valuations.

These 'telling' anecdotes, whilst local in nature, are symptomatic of a more universal problem in both the theory and practice of property valuation. There can be no doubt that a critical assessment of the field should come to the conclusion that property valuation is in crisis in a Kuhnian sense. There are a number of signs that lend credence to this view. First, it is now common cause that valuers cannot estimate market value with reasonable precision (Aluko, 2007; Havard, 2001; Crosby, 2000). Experiments around the world have repeatedly demonstrated that even the most experienced and reputable valuers come up

with significantly different valuations for same properties. And significantly there have been, to date, no convincing explanations for 'inaccurate' or widely differing valuations, other than an acceptance that valuation is not an exact science (Havard, 2001).

Traditionally, the inability of valuers to achieve reasonable precision in estimating market value has been taken care of by the notion of a permissible bracket around a 'correct value'. Setting aside for the time being the idea that each property has a correct value, it is evident that the extent of this bracket is itself problematic. UK courts have set the bracket at between 10 and 20 per cent (Crosby, 2000). A review by Crosby (2000) reveals that nearly 75 per cent of decisions fall within a bracket of 10–15 per cent. Of much more interest is the observation that the courts in recent cases are widening the permissible bracket, suggesting a reduction in the expectations of valuers by the courts. Even then, Crosby goes so far as to suggest widening the permissible bracket further, to 35 per cent. Related developments have included eschewing the use of point estimates of value in favour of value ranges (Aluko, 2007) and couching valuations in probabilistic terms (French and Gabrielli, 2004).

The second sign of crisis is a lack of clarity, after all these years, about the nature of market value and what it is that valuers in fact do. The staggering array of market value definitions (see Schlaes, 1984) is eloquent testimony to this confusion. Market value is variously understood to be several things: symbol, norm, opinion, inference, expectation, prediction, event, ideal (Schlaes, 1984). Perhaps the point of greatest disagreement is between those who define market value as the *highest* price and those who define it as the *most probable* price. Related to that is confusion about whether market value is normative ('what should be') or positive ('what is'). Thus valuers are alternatively seen either as 'value estimators' or as

'value predictors' (Lusht, 1981). Even recent attempts at harmonising definitions by the International Valuation Standards Committee (IVSC) do nothing to diminish these underlying tensions.

The third and final sign of a profession in crisis is a lack of intellectual progress. The most obvious evidence of this is the lack of any real debate in the field to suggest a healthy rate of knowledge creation. On the contrary, there is much evidence of stasis, if not decline. Basic valuation theory and methodology, for instance, have remained the same for eons. Even the recent 'explicit' DCF approaches, while more sophisticated than traditional methods, do not represent a fundamental change in underlying theory or provide more accurate valuations. The suspicion in fact is that they serve to meet the need for valuers to display more erudition in the face of more numerate peers from the finance profession. It is telling that the newer, esoteric approaches (see Pagourtzi *et al.*, 2003, for examples) have had limited uptake in practice.

Roulac *et al.* (2004) review the state of global valuation research, based on an analysis of papers presented at four major international real estate conferences. The evidence presented by the authors shows both a steady decline in valuation-related papers and a shift in interest away from valuation methods to valuation processes. This loss of academic interest bears the hallmarks of what Imre Lakatos described as a degenerating research programme. As Lakatos (1978) puts it, a progressive research programme is productive, with theory leading to the discovery of hitherto unknown novel facts. This cannot be said of valuation research, whose guiding theory is incapable of predicting new facts. Rather, characteristic of degenerating programmes, theories may be 'fabricated' only in order to accommodate known facts (Lakatos, 1978). For example, given the now well-known fact that valuers cannot credibly estimate market

value, explanations are increasingly being sought in 'behavioural' theories (see for instance, Havard, 2001).

This article aims to show that the edifice on which modern property valuation theory rests is so unsound as to warrant a paradigm shift in the original sense of the word. To put it in Lakatosian terms, the 'hardcore' can no longer provide the necessary support for a progressive research programme in property valuation, one that can adequately deal with the crisis as highlighted earlier. Using the vantage-point provided by thin property markets and insights provided by transaction cost theory, this article argues that market value as conventionally understood cannot legitimately be determined. This is because market conditions necessary for its emergence as a knowable, determinate and autonomous figure do not exist in practice. The article explains the continuing importance of valuers in the property market in terms of an alternative theory of market value, one which emphasises its role as a transaction-cost-minimising device.

The rest of the article is organised as follows. The next section reviews the neo-classical basis of modern value theory. The intention here is to show that the problems in valuation theory and practice are rooted in fundamental assumptions underlying neo-classical economic theory. Section 3 introduces a transaction cost critique of neo-classical economics and assesses the implications of this critique for valuation theory. This sets the stage for the development of an alternative theory of 'market value' in section 4. The concluding section applies this alternative theory to the problems in valuation theory and practice highlighted earlier. The intention here is to demonstrate its superior explanatory powers. The section ends with brief comments on the implications of this theory for the valuation profession and users of their services.

2. House of Sand and Fog: Neo-classical Economics and Value Theory

2.1 Ontological, Epistemological and Methodological Foundations

Modern value theory is based on the ontological and epistemological perspectives of neo-classical economic theory. Western thought has traditionally perceived the nature of 'reality' in terms of two contrasting ontological traditions. A 'Heraclitean' ontology of *becoming* (after Heraclitus, c.535–c.475 BC) places emphasis on a changing and emergent reality, whereas a 'Parmenidean' ontology of *being* (credited to Parmenides (c.515–c.445 BC) places a different emphasis, on a permanent and unchanging reality (Gray, 2004). But, and as Gray (2004) observes, it is the latter that has held sway in Western philosophy.

Being ontology is clearly the dominant perspective of neo-classical economic theory. Under this perspective, reality is seen as being composed of clearly formed entities with identifiable properties, in contrast to a Heraclitean emphasis on formlessness and chaos (Gray, 2004). And, significantly, once entities are held to be stable they can be represented by symbols, formulae, words and concepts. Thus a representationalist epistemology results in which signs and language are taken to be accurate representations of the external world (Gray, 2004). Gray argues that this representationalist epistemology orientates thinking towards outcomes and end-states rather than processes of change.

Being ontology results in particular epistemological positions. The dominant one is an objectivist epistemology which holds that reality exists independently of consciousness. A theoretical perspective closely linked to objectivism is positivism. Positivism has of course been the dominant paradigm of neo-classical economics, its core argument being that economic reality exists externally to the researcher and that its properties can be measured directly through dispassionate

observation (Gray, 2004). In essence, positivism argues (Gray, 2004, p. 18) that

- Reality consists of what is available to the senses.
- Inquiry should be based upon scientific observation (as opposed to philosophical speculation) and therefore on empirical inquiry.
- The natural and human sciences share common logical and methodological principles, dealing with facts and not values.

Positivists view both the natural and social worlds as exhibiting empirical regularities. This is because both these worlds are argued to be subject to a strict set of laws, which science had to discover through empirical inquiry, using the 'scientific method'.

The ontological, epistemological and methodological perspectives of neo-classical economics underlie contemporary views about the nature of market value and how it may be discovered. First, market value is held to have an independent existence external to the valuer. Thus it is possible to separate valuations from market prices, the latter being evidence of true market values. This of course is the basis upon which valuation accuracy studies are premised. Secondly, market value is knowable, determinate and exhibits empirical regularities, such that it can be represented by mathematical symbols or formulae. Thirdly, in the process of determining market value, the valuer adopts a positivist approach. The valuer is held to be a dispassionate observer of the property market, objectively weighing evidence to arrive at appropriate conclusions. In essence, the valuer is a scientist, using the 'scientific method' to answer the question: what is the market value of this property? Hence the conventional view that valuers are mere 'score keepers' and do not predetermine values or influence prices.

These assumptions are fundamental in contemporary valuation theory and practice. In a following section, we briefly return to them

to make the point that they are not valid. This article, however, is less about this level of analysis. The interest is in less fundamental, but nevertheless, basic assumptions of neo-classical economics and how these have influenced valuation theory and practice.

2.2 Basic Assumptions of Neo-classical Economic Theory

Neo-classical economic theory has been the dominant paradigm in economics for much of the past century and continues to be so up to the present. Its dominance has been attributed to its strong theoretical foundations, in particular the scarcity-of-resources postulate (hence the competition imperative), the concept of supply and demand, and the role of prices in resource allocation.

Traditional neo-classical economic theory is based on a number of assumptions about the nature of the economic world and of man as the principal actor in that world. North (1990, p. 19) summarises the behavioural assumptions of traditional neo-classical economic theory as follows

- The economic world is reasonably viewed as being in equilibrium.
- Individual economic actors repeatedly face the same choice situations or a sequence of very similar choices.
- The actors have stable preferences and thus evaluate the outcomes of individual choices according to stable criteria.
- Given repeated exposure, any individual actor could identify and would seize any available opportunity for improving outcomes and in the case of business firms would do so on the pain of being eliminated by competition.
- Hence no equilibrium can arise in which individual actors fail to maximise their preferences.
- Because the world is approximately in equilibrium, it exhibits at least approximately

the patterns employed by the assumptions that the actors are maximising.

- The details of the adaptive process are complex and probably actor- and situation-specific. By contrast, the regularities associated with optimisation equilibrium are comparatively simple; considerations of parsimony therefore dictate that the way to progress in economic understanding is to explore these regularities theoretically and to compare the results with other observations.

These assumptions underpin the neo-classical model of exchange, as epitomised by the concept of the perfect market, with its assumptions of many buyers and sellers, product homogeneity, perfect factor and product mobility and full information. This model assumes that actors in the face of scarce resources have stable preferences, are rational and have full information on the alternatives and consequences of their actions. The actors' behaviour is modelled in terms of maximising an objective function, behaviour described by some as 'the hedonistic calculus of *homo economicus*'.

These assumptions together with the assumption of perfect competition result in equilibrium tendencies in markets and the efficient allocation of resources. Under this model, the market is frictionless and efficiently adjusts to new conditions because transaction costs are zero. The emphasis is on informational efficiency, at the core of which lies the proposition that there will be a knowable and determinate price established in an efficient market (Keogh and D'Arcy, 1999). Property valuation is largely premised on this proposition.

2.3 Neo-classical Economics and Value Theory

Contemporary value theory is based on traditional neo-classical economic theory.

It has to be acknowledged that there have been some shifts in neo-classical thinking. As MacLennan and Whitehead (1996) point out full information, perfect competition and instant equilibrium are no longer seen as necessary assumptions. This shift, however, has not affected contemporary valuation theory. Thus, at the most general level, property values are seen to be determined by the interaction of supply and demand in property markets. The property market is viewed as reasonably being in equilibrium, with market prices indicating the state of the market at any one time. **Market prices are held to be proxies of market value.**

The International Valuation Standards Committee (IVSC) has defined market value as

the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion (French, 2006, p. 87).

It is important to note that this is a price definition (French, 2006). The basic concept is that a market valuation is an attempt to identify the exchange price in the marketplace at the date of valuation (Crosby, 2000). A market valuation is therefore an estimate of price and market value is nothing other than the equilibrium price of neo-classical economics.

Regardless of wording, any definition of market value must assume certain competitive conditions (McParland *et al.*, 2000). It is not unreasonable to say that the internationally agreed definition of market value assumes, or is based on, the traditional perfectly competitive market of neo-classical economics. The equilibrium price (i.e. the market value) set in such a market is both determinate and autonomous. Valuation is the process of attempting to discover this figure,

with 'valuation accuracy' a measure of the degree of success in this endeavour. Further, the nature of competition in such a market is such that no single actor can influence prices. This makes it possible to separate valuations and prices; hence the assumption that valuers are unable to influence prices.

3. Nemesis: Transaction Cost Critique of Neo-classical Economic Theory

This section aims to show that the basic neo-classical assumptions on which valuation theory rests are not valid. Before engaging in the detailed discussion, however, it is appropriate to make a few comments on the ontological, epistemological and methodological positions raised in the previous section. The fundamental issue appears to be the extent to which a *being* ontology and its resultant epistemology are an appropriate perspective for engaging in economic enquiry. First, the assumption that economic reality resembles reality in the natural sciences is, at best, tenuous. Human beings are not inanimate objects whose behaviour exhibits empirical regularities capable of being represented by symbols or formulae. Secondly, the extreme rejection of normative analysis appears to be misplaced. Human beings cannot be independent, dispassionate observers of social phenomena, even under the rubric of the 'scientific method'. It is widely recognised that observations tend to be value laden, with the social environment exerting an influence on the observer and vice versa.

Matters of ontology and epistemology are important in the theory and practice of property valuation. As Plattner (1985) points out, the nature of value, its source and its relationship to price and market behaviour have long been topics of concern among philosophers, economists and property professionals. The fundamental philosophical question is whether value can have an independent

existence outside the subject—in this case, the valuer. The assumption that a personal, subjective concept like value can assume an impersonal objective dimension is one that is clearly problematic.

This paper is, however, interested at a less fundamental level of analysis. Criticism of neo-classical economic theory, particularly its basic assumptions, has in recent times raised serious doubts about its usefulness in dealing with real-life situations. North (1990, p. 24) provides a cogent critique of each of the basic behavioural assumptions of neo-classical economic theory, outlined earlier

- For some purposes, the concept of equilibrium is a valuable tool of analysis, but for most of the issues that we are concerned with there is not one equilibrium, but multiple equilibria that arise because there is a continuum of theories that agents can hold and act on without ever encountering events which lead them to change their theories.
- Although individual actors face many repetitious situations and can act rationally in such situations, they are also confronted with many unique and non-repetitive choices where the information is incomplete and where outcomes are uncertain.
- Historical evidence suggests that preferences change over time.
- Actors would certainly like to improve outcomes, but the information feedback may be so poor that an actor cannot identify better alternatives.
- Competition may be so muted and the signals so confused that adjustment may be slow or misguided and the classic evolutionary consequences may not obtain for long periods of time.
- The condition of the world throughout history provides overwhelming evidence of much more than simple non-rational co-operative behaviour.

- The behavioural assumptions of economists are useful for solving certain problems. They are, however, inadequate to deal with many issues confronting social scientists.

This critique stems from the realisation that real-life markets behave very differently from the traditional competitive markets of neo-classical economics. The major, but by no means the only, reason for this lies in the fact that actors in real-life markets are faced with positive transaction costs, mainly arising from incomplete information. As Furubotn and Richter (1998) put it, once transaction costs are introduced, the acquisition of unlimited knowledge becomes too expensive or impossible. In addition individuals have restricted ability to handle data and formulate plans. This leads to the concept of bounded rationality where people can be seen as intendedly rational, but not ‘hyper-rational’. This implies that the preferences of decision-makers are at any one time to be seen as incomplete and subject to change. And, significantly, the idea of ‘bounded rationality’ arising from incomplete information means that for most issues of analytical concern “there is not one equilibrium, but multiple equilibria” (North, 1990, p. 24).

The traditional competitive market, based on full information and costless exchange of valuable commodities having only two dimensions (i.e. price and quantity), can be applied to property only in a very highly abstract sense. One of the distinguishing features of property markets in comparison with other markets are high transaction costs (Liu *et al.*, 1990; Clapp *et al.*, 1995). In particular, it is a well-known fact that participants in the property market face information problems (Adair *et al.*, 1998). Information problems arise due to the fact that market transactions are complex and often shrouded in secrecy, the product is not homogeneous and information is costly to obtain (Evans, 1995;

Baryla and Zumpano, 1995; Miceli, 1988). Yet, and as Evans notes

most of the literature on the property market is written as though it was the very paradigm of a neo-classical perfect market—many buyers, many sellers, homogeneous product, full information etc (Evans, 1995, p. 6; also see comment by Watkins, 1998, p. 57).

This approach holds that trade will establish meaningful prices which provide meaningful representations of value and property rights are acquired by those who value them most highly. This approach to the analysis of property markets lacks institutional or behavioural content and, significantly, tends to ignore many of the defining characteristics of property such as high transaction costs, illiquidity and information problems (D'Arcy and Keogh, 1998).

The point that is being made here is that the neo-classical idea that competition will always lead to equilibrium in property markets ignores the key *defining* features of property and thus has no basis in reality. Simply put, the market on which property valuation theory is based does not exist. The necessary conclusion from this is that market value does not exist, because the conditions for its emergence as an autonomous, determinate and knowable figure cannot possibly occur in reality. Evans sums up the case thus

In the case of most properties, a unique and determinate price is not fixed by the market. The crucial problem is that the necessary conditions for a perfect market are not fulfilled. It is not true that in every property market there is a homogeneous product with many buyers, many sellers and a high degree of knowledge ... A consequence of this relative inefficiency is that other, non-market, factors will affect the price at which a property is sold—factors such as buyer/seller psychology, the time the property is on the market, the role of real estate agents (Evans, 1995, p. 16).

As Evans goes on to argue, there is no *true market value* of a property, only a range of prices. According to him, the price at which a property is sold is just that, with other buyers or other sellers it could indeed have sold for a different price. It can be argued that the range of prices in property markets simply represents the multiple equilibrium positions of individual buyers and sellers.

To buttress the arguments that have been made so far and to anticipate those yet to follow, we wish to end this section with a 'thought experiment'. Imagine a continuum with no market at one end (i.e. no participants and/or product) and the traditional perfect market at the other end. One can envision, for a specific product, a movement from 'no market' to a 'perfect market' by increasing the number of participants, increasing product homogeneity and increasing information availability. Put differently, by progressively lowering transaction costs, one can engender movement on the continuum towards the perfect market such that when these costs are zero, the perfect market will have been attained.

At a certain point on the continuum, when transaction costs are zero and a perfect market has arisen, market value as a determinate and autonomous figure will emerge. Paradoxically, however, the point at which market value emerges is also the point at which valuers become redundant. In a perfect market with full information about prices being paid elsewhere, participants do not need valuation advice. In fact, in such a market there will be a single price, which is also the market value, and all participants will have knowledge of it.

It would seem therefore that valuation theory is faced with the simultaneity problem akin to that of quantum physics where, in this case, market value cannot exist simultaneously with the need for valuation. Valuers are required when transaction costs are high but at this point market value does not exist. Conversely, valuers are not required when

transaction costs are zero and market value has emerged.

4. Games and Players: Market Value as a Rule of the Game

Given that market value could not possibly exist in property markets, what is it that valuers actually do to warrant their huge influence? The answer to that question can be found in the predictions of transaction cost theory. It will be argued that transaction cost theory does not only explain this conundrum but provides a better explanation for many of the problems in valuation theory and practice highlighted at the beginning of this paper. In short, transaction cost theory provides the 'hardcore' of an alternative paradigm in property valuation theory and practice.

The concept of transaction cost is probably the most significant theoretical contribution of the 'new institutional economics' (NIE) which in turn is widely considered to be the most significant theoretical development in economic theory in recent times (space precludes a detailed discussion of the NIE, but readers are referred to Furubotn and Richter, 1998, and Eggertsson, 1990, for good introductory texts).

There are several types of transaction cost but in this paper we are interested in those costs arising from the need to use the market system. These market transaction costs arise principally due to information problems. When information is costly, various activities related to the exchange of property rights between individuals give rise to transaction costs (Eggertsson, 1990; North, 1990). Eggertsson (1990, p. 15) lists these costs as follows

- The bargaining that is needed to find the true position of buyers and sellers.
- The making of contracts.
- The monitoring of contractual partners to see whether they abide by the terms of the contract.
- The enforcement of a contract and the collection of damages when partners fail to observe their contractual obligations.
- The protection of property rights against third-party encroachment.

High transaction costs cause market failure. Thus if the transaction costs are too high, exchange will not take place or will be severely constrained (Eggertsson, 1990). A key thesis in the NIE is that economic agents establish institutions to reduce the 'ubiquitous uncertainty' (North, 2005) inherent in human interaction and/or to overcome market failures caused by the presence of risk and imperfect information. Institutions have been defined as the humanly devised constraints that shape human interaction, together with their enforcement mechanisms (North, 1990). Heltberg (n.d.) defines institutions as rules, norms, habits and formal hierarchies that shape agents' actions and expectations.

When it is costly to transact, economic agents need institutions to facilitate exchange. Using a sports team analogy, institutions are seen as 'the rules of the game' and market participants the players (North, 1990). Just like in a sports game, institutions simplify human interaction by a system of rules and procedures. By limiting the choice-set of actors in complex or uncertain situations, discretionary action is constrained and human interaction is structured into predictable and manageable ways. Pursuant to that, institutions serve a number of important economic functions, such as handling situations with missing or asymmetrical information, facilitating and enforcing market and non-market transactions, substituting for missing markets,

- The search for information about the distribution of prices and quality of commodities, ... the search for potential buyers and sellers and for relevant information about their behaviour and circumstances.

co-ordinating the formation of expectations, encouraging co-operation and collective action and reducing transaction costs (Heltberg, n.d.).

As has been repeatedly emphasised, property markets are characterised by high transaction costs caused by information problems. In particular, participants need information about the distribution of prices given a property of given specifications. Further, once a prospective transaction partner has been found, participants need 'anchoring' information with which to assess what is likely to be their partner's true position, in order to set the parameters for bargaining. This information may not be easily available and/or may be costly to acquire. These information problems therefore create incentives for institutions specialising in information intermediation to evolve (Miceli, 1988). Such institutions (and organisations) can take advantage of economies of scale in information gathering, lowering transaction and information costs for market participants (Baryla and Zumpano, 1995).

This is the role played by valuers (and estate agents). The principal reason for the existence of these professions can be attributed to information problems in property markets (Miceli, 1988). They are *producers* and *sellers* of information about property markets, performing the important function of bringing together buyers and sellers who generally lack information. It is argued here that valuers are not merely passive gatherers of market information. On the contrary, they actively create information where none existed to enable property markets to function.

In the face of information problems in property markets, the concept of 'market value' is an institutional innovation, a 'rule of the game' without which these markets will not function well. By estimating the 'market value' of a property, a valuer is effectively laying down a rule for the market in question. The word 'rule' is used, not in the injunctive

sense, but rather in the sense of a norm or convention. It must be stressed that valuers do not consciously set out to impose these norms on the market, but this nevertheless is the effect of their actions. Once 'market value' has been provided, market participants need not personally search for the distribution of prices. Further, it provides an anchor upon which bargaining between the participants can be based. 'Market value' is thus a device for lowering transaction costs. Its function is to stabilise market expectations by providing pricing information.

A number of conclusions follow from conceiving market value as a rule of the game. First, like all rules, market value is normative. This means that it need not have an objective independent existence 'out there'. Secondly, market value may be established for any market, whether thin or actively traded. It certainly does not need the traditional competitive market for its establishment. Thirdly, valuers can and do influence, even determine, prices in property markets.

Conceiving 'market value' as a rule of the game raises the question of correspondence between it and economic benefits flowing from the property in question. Rules can of course be entirely arbitrary. It is thus conceivable that 'market value' could be set at a level that bears no relationship to the productivity of a given property. This, however, is unlikely. Legitimacy, and therefore acceptability, of all rules requires that they be anchored on a widely acceptable framework. For example, the legal code of any country (an example of an institutional innovation) needs to correspond with some fundamental notions of morality in the given society for it to have legitimacy and stability. Laws that are in conflict with the moral order of a society cannot last. Similarly, there has to be some relationship between the figure of market value for a given property and its economic productivity.

The corollary is that even if 'market value' is a rule, its magnitude cannot be arbitrary.

Stability and legitimacy require that there be some correspondence between its magnitude and economic benefits generated by the property. This correspondence, however, is not so much mathematical as it is heuristic. Thus supply and demand will broadly explain the levels of market values. Having said that, it is entirely possible that 'market value' could be established by *fiat*, as has happened in the past in some communist states. It will still serve its function of structuring exchange as long as all or most participants in the market accept it and have no alternative information.

5. Requiem for the Artist? Some Thoughts on Values, Valuers and the Future

Does this alternative theory of market value provide superior explanatory powers for the practical and theoretical valuation problems highlighted at the beginning of the article? The answer is yes. With regard to the valuation cases from Namibia, the common denominator that links them together is lack of market evidence caused by thin property markets. In these circumstances, there will be, as expected, severe information problems for participants especially in respect of pricing.

Each of the three cases discussed illustrates some aspect of our argument. The first case, that of the landmark building, illustrates how valuers can and do create 'market value' *ex nihilo*. In the absence of market evidence, the given market value was effectively because the valuer had said so. The client's acceptance of the figure, caused in part by his acceptance that the valuer had a (professional) right to make this determination, completes the equation. Whereas before the valuation the client had only bricks and mortar to contemplate, the valuer provides a precise monetary equivalent. This information enables the client to make certain decisions such as, in this case, how much tax to levy on the property. It is evident that a different valuer would have

come with a vastly different estimate, with consequent differences for the tax liability of the property owner.

The second case, that of the practice of relying on dated municipal valuations for pricing information, suggests that the fact that 'market values' are dated is of no consequence as long as (almost) everyone in the market accepts that the figures are legitimate. Thus potential trading partners will point to municipal valuations to justify their asking or offer prices. This in turn suggests that absolute levels of 'market values' are not as important as the perception that they are consistent with a norm. This is consistent with transaction cost theory, which predicts that, in a market context characterised by limited information, it is in everyone's interest 'to play by the rules'. The final case illustrates both how valuers can create value where none existed and how that information becomes the basis for the continued functioning of property markets.

The alternative theory of market value presented in this article brings a radically different perspective to the universal problem of valuation accuracy. Since there is no correct market value and market prices are nothing more than evidence of transaction-specific equilibria, the notion of valuation accuracy must fall away. Simply put, there is no external benchmark against which to judge an individual valuation as inaccurate. Seen in this light, the reported wide variations in valuations of same properties by different valuers are to be expected and are entirely justified. These variations are easily explained as arising due to information problems faced by valuers, in their assumed role of surrogate buyers. Each estimated market value is simply the equilibrium position of the concerned valuer, given the information-set available to him or her. The implication of this of course is that, rather than widening it as suggested by Crosby (2000), the notion of a permissible bracket around a correct value must be discarded.

This raises the question of how valuers could be held to account by the courts in the performance of their duties. In the absence of a correct value, valuers can only be judged against each other in relation to how well they adhere to industry norms and professional standards. They could also be held to account for negligence under the common law.

Valuation variation, rather valuation accuracy, is therefore the relevant test for professional competence. It is contended that the real function of valuation methods and standards is to reduce valuation variation, rather than to increase valuation accuracy. Valuation methods and standards must be seen as mere protocols (see Kummerow, 2006) whose purpose is stabilise the outputs of many valuers. The concept of market value as a rule requires a reasonable degree of precision of market value estimates.

The longstanding confusion about the nature of market value and what valuers actually do is explicable in terms of contradictions between reality on the one hand and the neo-classical basis of value theory on the other. In the frictionless world of the neo-classical competitive market, the question of whether market value is the highest or most probable price does not arise. Similarly, there is no question whether market value is normative or positive. Under these market conditions, the highest price is the most probable, in fact, only price. Further, under these conditions what the price should be, is.

The reality on the other hand is very different. Let us take the example of a single property placed on the market. This property will attract a normal distribution of offers from potential buyers. The highest price will be at the upper end of the distribution while the most probable price, in statistical terms, will be at the centre. **Bearing in mind that actual sale prices are used as proxies for market value, the question appears to be at what point on the distribution the property will change hands.** In practice, a seller of property will

seek the highest offer possible *that he or she is aware of*. In these circumstances, the property will exchange near the upper end of the distribution, not at the mean or modal value. In fact, assuming that all sellers are 'rational', *all* observed sales will be at the highest price obtainable. This leads many valuers to define market value as the highest price possible.

Defining market value in terms of the upper end of a normal distribution is, however, at odds with most definitions and with intuition. The closer one gets to the upper end of the distribution the closer one gets to atypical or 'special purchasers' and therefore the less representative of market sentiment the sale price becomes. Most definitions of market value assume typical buyers and sellers. Intuitively, most people would not recognise special purchases (or distress sales for that matter) as good evidence of market value. Common sense requires that market value be 'representative' of the market in question and must therefore lie at the centre of the distribution. Valuers who take this view define market value as the most probable price.

The confusion can easily be resolved by making explicit the assumptions regarding information available to the seller and the extent of the market in question. If the seller has full information about all the potential offers, the property will sell at the highest price. The reality, however, is that the seller will not have full information about the size and distribution of offers. From his or her point of view, the sale will take place at the highest possible price. From the point of view of an omniscient observer, however, the property will, *a priori*, sell at the most probable price. This is likely to be an 'average' price, if only because there will be more buyers at that point and therefore a higher probability of consummating the transaction. It has to be remembered that market value is an estimate of a sale price that has not taken place and will probably never take place. The realised price is therefore entirely a matter of probability.

There is another sense in which the contradictions between reality and the theoretical apparatus are a source of confusion. The reality is that value is, like truth, beauty, goodness and similar abstractions, a highly personal and subjective phenomenon. No one can say with confidence that such abstractions exist independently of our consciousness of them. Attempts to quantify them must overcome formidable conceptual and practical challenges. Yet, as argued elsewhere in this article, the apparatus on which modern valuation theory rests assumes that market value exists independently of individual consciousness and that it can be quantified. This is contentious. However, it raises philosophical questions that go beyond the remit of this article.

It will be apparent that the alternative theory of market value advanced in this article deals with the uncertainties regarding the nature of market value and the function of valuers. Since market value in the sense of a determinate and autonomous market-derived figure does not exist, the question of whether it is the highest or the most probable price does not arise. In addition, the concept of valuer-determined 'market value' as a rule makes market value normative. This is not inconsistent with the commonsense notion of value as a highly personal and subjective phenomenon.

What insights does the theory advanced in this article bring to what we referred to as a degenerating research programme in property valuation? We have noted how there has been both a decline in valuation research and a shift in interest, away from methods to processes. The reasons for this are not hard to see. Much of the research in valuation is premised on the actual existence of a correct market value. In these circumstances, the main goal of research would be to improve the accuracy with which valuers estimate this value. In the absence of a correct market value, however, the productivity of the research

effort must inevitably fall, resulting in a decline in academic interest. This is exactly what is happening in valuation research. No improvements in methodology or technique will enable valuers to find that which does not exist.

The shift in interest to valuation processes and behavioural aspects is therefore predictable and entirely appropriate. There is, however, a sense in which this reflects mere groping around—largely descriptive writing, lacking a firm mooring in economic theory. Property valuation as currently conceived is essentially a matter of economics. It is imperative, therefore, that new directions in research remain grounded in economic theory. It is argued that transaction cost theory provides the necessary theoretical foundation for this shift and, more significantly, for a new paradigm in property valuation research.

By way of final comment, it is appropriate to reflect briefly on what a future without market value, as conventionally understood, holds for the valuation profession. Valuers have an important role to play in property markets, as evidenced by the continued demand for their services. By creating value where none existed and by providing necessary pricing information, they make it possible for markets to function. Without this service, especially in thin markets, banks cannot lend, taxes cannot be assessed, property cannot be compulsorily acquired and normal trading will be severely hamstrung.

Any predictions of the imminent demise of the valuation profession would therefore be an exaggeration. A future without market value, however, calls for a fundamental reappraisal of what can legitimately be expected from valuers. The most obvious change will be a shift in focus, from attempting to estimate market value to the calculation of individual worth. There is some evidence that this change in focus is already underway. In addition, there will be need for a new perspective on matters such as valuation accuracy, valuer competence

and property index construction. Investors in particular will be expected to view valuation-based measures of property performance with a good deal of circumspection. Finally, the idea that market value as established in practice is a rule lends theoretical support to the growing realisation that valuations are just a pricing mechanism and do not in any way display the intrinsic value of a property.

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