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## Introduction and Overview

The market value of real estate value falls under the broader umbrella of economic value. ‘Value’ itself is a concept that has several dimensions. Thus one can speak of spiritual value, moral value or, indeed, economic value. These dimensions of value share a common root in that they all link subjects and objects via an assessment of goodness or worth. They are however also different in terms of subject matter and general orientation. A complete theory of value should be able to unify them, accounting for both similarities and differences. The obstacles which stand in the way of the development of such a theory are however daunting, and the prospects for success rather limited. This necessarily requires proceeding in an incremental or partial manner. From the outset, therefore, it must be stated that this book is about economic value, value that is attached to real estate as a necessary adjunct to the conduct of commerce and other social activities.

The question of the nature of economic value, of its magnitude and how it might be measured, has exercised the mind of man as soon as the necessity for, and practice of, trade in goods with others arose. These questions have been the subject of centuries of scholarly reflection, and will no doubt continue into the future, a clear testimony to the intractability of the problem. It is the case, however, that whatever additional light is shed on the nature of economic value as applied to real estate will have an illuminating effect on the other dimensions of value.

The basics of the problem associated with conceptualising value can be summarized with the use of an analogy from the physical world. At the heart of scientific inquiry into the fundamental nature of material objects lies the particle–wave duality, i.e. whether matter is fundamentally ‘particle-like’ or ‘wave-like’. The fundamental nature of economic value for its part has been problematised in not one, but three dualities. The first is about the *nature* of value, whether value was *intrinsic* (i.e. in the good itself) or *extrinsic* (in the minds of those contemplating the good). The former is an objective conception, one that sees value as existing independently of human awareness or opinion, much the same way that the sound

of a falling tree exists, even when no one is around to hear it, or wills it away. There are good reasons to support an intrinsic conception of value. For example, it might be argued that a house has certain intrinsic qualities (a shelter from the elements for example) that make it of value irrespective of what anyone thinks. Extrinsic conceptions of value, on the other hand, see it as an entirely subjective phenomenon, one whose existence lies purely outside of objects, and in the consciousness of human beings who collectively constitute the market.

The second duality is with respect to *types* of value, as reflected in the relationship between *value-in-use* and *value-in-exchange*. The former relates an economic good to the value it provides to an individual use or user, whereas the latter relates the same good to the value that it provides to an aggregation of uses or users (i.e. value to society or 'the market'). Value-in-use and value-in-exchange need not be identical, and frequently do not coincide. This raises obvious practical and moral questions about which value should be privileged in the conduct of commerce and trade. The final duality is an artifact of the need for *quantification* of value, as reflected in the relationship between *price/cost* and *value*. In real estate valuation practice the former are frequently used as a proxy for the latter. The search for a measure of value (which is subjective) leads to prices (or cost) (which are objective), prices (or costs) which nonetheless may occasionally be patently or intuitively out of line with some notion of the 'intrinsic' value of the object in question.

This chapter traces the evolution of thinking around these problems. According to Sewall (1901) this evolution is marked by two main features: first is the growth of the conception of exchange value (at the expense of use value), and second is the advance of the subjective conception of value (at the expense of the objective conception). This evolution has been a natural consequence of two secular trends in world history. The first of these is the increasing importance of commerce and trade in social life, culminating in the twentieth century phenomenon of globalisation. In keeping with many other writers on the subject, Brue and Grant (2007) regard the 1500s as the dividing line in the evolution of commerce. There was little trade before 1500, with most goods produced for consumption, not sale, within the communities that produced them and little use of money and credit (*ibid.*). In contrast, markets and trade expanded rapidly after 1500, aided and spurred by the great explorations (*ibid.*). The money economy superseded the natural or self-reliant economy (*ibid.*).

This shift had implications for value thought. In an era when communities produced most of the goods that they needed, and were thus largely self-sufficient, the incentive to engage with the question of the exchange value of commodities was weak. Use value, on the other hand, provided the natural reference framework for the valuation of goods that were required to be crafted in order to satisfy individual needs. The expansion in trade networks and growth of the money economy, however, ruptured the intimate connection between the maker of goods and those who used them. In the words of Sewall (1990, p. 9):

When a natural economy is supplanted by a money economy, and producers become specialists, the satisfaction of wants comes to depend, in the first instance, upon purchase rather than production. That is, the individual who wants anything, goes out and buys it, instead of sitting down and making it, as under a natural economy he would commonly have been obliged to do. Thus the importance of buying and selling in the daily lives of people becomes immensely increased.

Two features of expanded markets have had implications for the evolution of valuation theory. These are the imperative to trade with total strangers on one hand, and the disconnection between the production processes for market goods from the parties to the exchange. These features require an external reference point for an appropriate exchange price, one that did not rely primarily on personal knowledge of production cost. Hence the ascendance of value-in-exchange, at the expense of value-in-use.

In tandem with the increased commercialisation of social life, the second broad secular trend which has influenced value theory trend has been the increased reliance on rationality and reason in the conduct of human affairs, and a concomitant decline in superstition and religion. The growth of secular knowledge has played the major role in this trend, the pivotal epoch being the ‘Scientific revolution’ that took place between the sixteenth and eighteenth centuries. The scientific revolution helped to fundamentally transform traditional views about society and nature. In an era where objects could, for example, be perceived to be intrinsically good or evil, it was natural for objective conceptions of value to predominate. That is to stay value in these circumstances would logically be held to be an intrinsic attribute of the good, and not arising from its perception. This in contrast with contemporary, more relativist and subjective conceptions.

As has been pointed out in Chap. 1, the standard theory of real estate market value is based on neoclassical economic theory. Neoclassical economic theory itself represents a stage, albeit an important one, in the evolution of economic thought. The history of economic value theory is, therefore, in essence the history of economic thought, given the centrality of the concept to the discipline. This history is summarized in the rest of this chapter. The discussion focuses on the broad ideas in each era. An attempt is made to simplify the key contribution on economic value associated with each period, though in a number of cases no such coherence could be distilled.

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## The Greco-Roman Period

It is conventional to start the discussion regarding the evolution of value theory from ancient Greece and Rome. This principally reflects the debt owed by Western intellectual tradition to Greek and Roman heritage. Ancient Greece waxed and waned in the period between 2000 BC and 250 BC, but the period between 480 BC and 323 BC, called the Classical period, is regarded as the most significant for the development of Greek thinking and civilization.

It is said that the predominant approach towards economic affairs in Ancient Greece was practical rather than theoretical, and that the attitude towards value or worth of a thing was to see it as intrinsic to the thing itself (Sewall 1901). The challenge for this conception of value lay in measurement at the time of exchange. The solution was to privilege the valuation of the owner or creator of goods in question. Thus for the Greeks the value of an object could only be established by the owner or creator, perhaps arising from their intimate knowledge of the effort that has gone into production.

Thus values of goods and services in ancient Greece were considered absolute and fixed by the owner or by general decree (Appraisal Institute 1983). This conception is hardly surprising, given the limited development of commerce during this period, on one hand, and the fact that most of the goods were produced by essentially self-sufficient craftsmen. In an environment where most exchange was discretionary it stood to reason that the owner of a good would not be predisposed to part with it unless on their own terms. Notions of justice in economic relations, which were pervasive during the period (see, for instance, Backhouse 2002), acted as a restraint against incentives to profiteer engendered by such an approach to value.

The principal figures in this period, whose thoughts on value are known, are the philosophers Plato (428–347 BC circa), and his pupil Aristotle (384–322 BC). Plato endorsed the predominant view of the times, commenting that ‘the craftsman assuredly knows the value of his work’ (Sewall 1901, p. 1). But the major contribution of the period comes from Aristotle. Aristotle devotes much of his thinking to value in the context of exchange. According to him, in order for things to be exchanged, things must be made equal, and the resulting equation is an expression of value (Sewall 1901). Thus his view was that value was expressed by the proportion in which things exchange for each other.

Aristotle’s principle contribution to value theory is twofold. Firstly, he located the basis of value in the usefulness or utility (therefore on demand for) of things. The second contribution was to identify the basis of value-in-exchange. He therefore provided the basis for the distinction between the use value and the exchange value of goods, the former consisting of the ability of a good to satisfy a specific need and the latter of the quantitative relationship in which one good is exchanged for another (Screpanti and Zamagni 2005). His conception of value as a ratio is in sharp contrast to the predominant ideas of the time as described above.

Aristotle however failed to satisfactorily deal with the question of the determination of the proportion in which things were to be exchanged. Thus, for example, should a house be exchanged for 10 sheep or 15? Or, to put it differently, was a house worth 10 or 15 sheep? This, of course, is a standard valuation problem, one with which contemporary valuers are familiar with, albeit with the sheep monetised. Aristotle’s solution was to posit the existence of a normative ‘just price’ for all goods. The just price was held to be an intrinsic and objective property of the good (Screpanti and Zamagni 2005). This price reflected the labour that both parties put into their goods of goods, and was just because the goods embodied equivalent amount of labour. In the example above, 15 sheep would be a just price

for the house if, and only if, the cost (or amount) of labour that went into rearing them would be equivalent to the cost (or amount) of labour that went into building the house. To Aristotle the justness of a price was on the basis of the equivalence of values exchanged (ibid.). Aristotle treated economic phenomena as subordinate to ethical considerations.

The Romans took over the Greek peninsula after a victorious battle in 146 BC, beginning what over the next several centuries years was to become the greatest empire that the world has ever seen. Like the Greeks, the Romans left an enduring legacy in the language, religion, architecture, philosophy, law, and government of nations around the world. Roman thinking on value however did not seem much developed, or if it was, there isn't much record of it. There isn't a single Roman thinker on the subject with the same stature as Aristotle, for instance. According to Sewall (1901) the Romans had no theory of value beyond a general conception of a degree of esteem, or the equivalence between two things, expressed by the amount of the price.

The Romans appeared to be more interested in price rather than with value, with the relationship between the two not well defined. In comparison to the Greeks, the Romans were more concerned with practical, rather than philosophical, matters and were similarly less constrained by ethical considerations. The Aristotelian concept of a just price did not exercise Roman minds. In matters of exchange, Roman law permitted freedom of contract, without any prescription about how prices under such contract should relate to the value of goods exchanged. There was nevertheless an awareness of the concept of value in material things, and that prices under contract may not accord with this value.

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## The Middle Ages

The Middle Ages refer to the period of European history between the fall of part of the Roman Empire in 476 AD to about the fifteenth century. The description 'middle ages' is a consequence of the division of European history into three periods. This period was preceded by the 'classical period' of Greek and Roman civilization, a period characterised by great advances in the economic, cultural and political life of Europe. The Middle Ages which followed was, in contrast, characterised by de-urbanisation, a reduction in the amount of commerce and trade, and a return to the simple subsistence living of the pre-classical period. This decline was only brought to an end by the Renaissance, a period which followed in the fourteenth century, in which there was a revival of classical traditions and learning.

From the point of view of the development of value theory, three features of the middle ages are significant, namely, the return to a subsistence economy, the loss of Greek and Roman learning and the influence of the Roman Catholic Church. The return to a subsistence economy brought with it what has been described as a labour theory of value (Sewall 1901). In a return to pre-Aristotlean conceptions, the value of goods was related to the labour of the seller. Because this was largely a feudal

society, the primary consideration for determining the worth of any good was the rank and status of the labourer, and not on the skills with which he made them, or their ability to satisfy the buyer.

The generalised loss of Greek and Roman learning meant that no significant advances in thinking on value could be made, at least not in the early parts of the middle ages. This put the Roman Catholic Church in a particularly strong position. The Church managed to preserve a significant part of Greek and Roman knowledge in its monasteries, including of writing. It was the only religion in Europe during the Middle Ages and used this vast religious influence, and its virtual monopoly of knowledge, to influence medieval thought. The most significant contributors to value theory in this period were therefore theologians, the most outstanding of which was Thomas Aquinas.

The unravelling of the medieval subsistence economy under the pressures of industrialization and increased commerce and trade made the labour theory of value increasingly untenable. The rise of a merchant class, whose bought and sold goods that they themselves did not make, often in distant places, created a rupture between labour and value. Increasingly, the original producer was so far removed from observation that no estimation of value according to his social position could be made (Sewall 1901).

The ecclesiastic authorities viewed this resurgence of commerce as potentially spiritually dangerous. Church thinking on matters of value was therefore motivated by the need to temper the excesses of materialism, to restrain the amassing of wealth and to ensure that justice in commercial relations prevailed. Value theory as espoused by the church was a mixture of Aristotelean ethics, medieval labour theory and Christian theology.

The notion of the presence of one 'true value' for each and every good can be traced to medieval theologians. The general view was that this true value was known through the esteem with which the general community, rather than the individual, regarded the good in question (Sewall, *ibid.*). The true value in turn was held to be dependent upon the labour expended upon it, estimated in accordance with the social rank of the owner and his standard of living (*ibid.*). Sitting uneasily alongside, were views that attributed value to the utility of the good and the level of supply in the market.

The concept of value as a *ratio* measuring the significance of goods or services demanded *in exchange* for other goods or services dates back to the middle ages. To the theologians, preoccupied as they were with fairness in trade relations, the true value was the 'just price'. That is to say, the just price was that price which reflected the true value. The theory of the 'just price' was, of course, derived from Aristotle. The just price was perceived to be an intrinsic property of a good, as it expresses its intrinsic value. It was believed that the just price must be such as to guarantee commutative justice, that is, equal exchange, in such a way that nobody can obtain more than he gives from the exchange of goods (Appraisal Institute 1983). In practical terms, the just price was to be fixed by decree from civic authority, something that was quite difficult to do as economic relations grew more complicated (Sewall 1901).

The key contribution to much of this thinking about value during the Middle Ages comes from St. Thomas Aquinas. In the *Summa Theologica* St. Thomas asks questions such as: Is it lawful to sell something for more than its worth? What are the obligations of buyers and sellers with regard to transactions? Is it a sin to take usury for money lent? St. Thomas taught that value was a moral concept. To sell a thing for more than its worth he regarded as immoral. The notion of fairness has survived to the present as in the concept of *fair market value* (Appraisal Institute 1983).

Beyond the emphasis on the moral nature of the just price, St. Thomas argued that everything had an intrinsic true value which was not necessarily the price at which it sold for. He thus had a clear grasp of the distinction between value and price. Further, St. Thomas recognized that the true value did not necessarily depend upon the personal estimates of either the buyer or the seller, but rather that of the community in general.

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## Mercantilism

The doctrine known as mercantilism dominated Western European economic policy and discourse from the sixteenth to late eighteenth centuries. Mercantilism refers to the system of merchant capitalism which replaced the self-sufficiency of the feudal social structure of the Middle Ages, and which held sway from 1500 to 1776 (Brue and Grant 2007). Mercantilism was associated with increased urbanization, the expansion of trade and the appearance on the social scene of the merchant class. This merchant class increasingly began to play an intermediary role between producers and consumers (ibid.).

During this period, economic activity in Western Europe was associated with overseas exploration, colonisation, and commerce. Mercantilism focused on wealth as a means of enhancing a nation's power. National wealth was equated with an influx of gold into the national treasury. This required international *trade*, with a country preferably exporting more than it imported.

Mercantilism is associated with the transition from the 'age of moral philosophy' to the 'age of political economy' (Brue and Grant 2007). The focus on political economy brought with a more coherent organization of economic thinking, giving rise to more systematic theories (ibid.). Thus, in terms of value theory, the transition was marked by a shift from religious, moral and philosophical concepts, to pseudo-economic concepts, based on notions of intrinsic value and extrinsic value (Ring and Boykin 1986). The latter constituted objective value as moulded by the forces of supply and demand (i.e. price) whereas intrinsic value was a measure of the object's inherent ability to render service or satisfaction in use, as conceived by canon law (Ring and Boykin 1986; Sewall 1901). This transition is of great importance in the history of value theory. The problem was no longer what value should be, but what it is (Sewall 1901). According to Sewall (ibid.) the recognition of value as involving an economic as well as moral dimension marks the most distinctive advance of the mercantilist era.

The predominant approach to value, at least in the early parts of the mercantilist era, was utilitarian. Given the importance of trade, ideas about value began to be influenced by prices paid for goods and the contractual relations that governed exchange. These prices were determined in competitive markets and by voluntary agreement, and not by a superior ecclesiastic or secular authority (Sewall 1901). Value (or merchant profits) was thus closely associated with market prices of goods, which in turn reflected the demand for them and, ultimately their utility (Screpanti and Zamagni 2005). As Sewall (1901), citing a Mercantilist scholar, puts it, whenever opposite parties, acting under conditions that ensure equality of advantage, agree upon a price, it is a just price.

The focus of Mercantilists thinking was on exchange value (i.e. price). Mercantilists thus disregarded cost of production as an element in determining value, accounting for it by way of utility and need (Sewall 1901). The reason for this is that they approached the subject from the perspective of exchange, and not from production, as was the case in the Middle Ages (*ibid.*).

Notable contributors to value theory in the mercantilist period include Bernado Davazanti, Geminiano Montanari, Nicholas Barbon, John Locke and William Petty. Davazanti, in a book published in 1588, attempts to construct a cogent utility theory of value (Screpanti and Zamagni 2005). He advanced the idea that the relative value of goods depended upon the 'happiness' (i.e. utility) that they are capable of procuring (Sewall 1901). Value of goods, according to Davazanti, depended upon their utility and quantity available i.e. it was not absolute utility that mattered but rather utility in relation to quantity available (Screpanti and Zamagni 2005). In terms of his conception, the effect of scarcity was to increase the use value of goods, and hence the prices at which they can be sold (*ibid.*).

Montanari, writing almost a century later, in 1680, posited a similar utility theory of value. Montanari argued that it is was desires of men which measured the value of things and that prices would vary in line with changes in tastes (Screpanti and Zamagni 2005). Montanari linked these desires to the rarity of the goods desired (*ibid.*). Thus scarcity rendered any commodity precious and abundance rendered it cheap (Sewall 1901). Montanari understood that exchange value depended upon personal valuation which in turn depended upon subjective utility (*ibid.*).

Nicholas Barbon advanced this strand of Mercantilist thought, that value was not an intrinsic quality of things but that it depended upon human wants. Barbon's theory of value, published in 1690, is surprisingly modern. As summarised by Screpanti and Zamagni (2005, p. 42), Barbon's conception of value has three key postulates. First, the natural value of goods is simply represented by their market price. Second, the forces of supply and demand determine the price. Finally, the use value is the main factor on which the price depends. In essence, Barbon's idea was that market value was determined by the competition of subjective valuations (Sewall 1901).

The ideas of Davazanti, Montanari and Barbon, that value depended primarily upon utility, marked a significant departure from medieval thought. The significance of their exposition lay in the view that value depended upon the capacity of



objects to produce happiness, and not upon their intrinsic nature. Thus, according to this conception, value was to be understood as arising from the side of the nature of man and not from the side of the natural qualities of the objects. This led to the conception of value as a subjective and not objective phenomenon. These ideas foreshadowed the Austrian or marginal utility school of thought that would emerge in the second half of the nineteenth century (to be discussed below).

The English philosopher John Locke (1632–1704) is credited for clarifying the mercantilist distinction between ‘natural’ (i.e. intrinsic) and ‘marketable’ value. Locke explained that the former depended upon utility while the latter was a relation in exchange (Sewall 1901). According to Locke (*ibid.*), the intrinsic worth of anything consisted of its fitness to supply the necessities of life. Marketable value on the other hand denoted a proportion in which two things which are exchanged stood in relation to each other.

Sewall (1901, p. 67) summarises the evolution of value thought in the mercantilist period thus:

The idea of a ‘true value’ was displaced during this period by that of a ‘natural value’, i.e. that value that would exist under conditions of free and equal competition. . . (In addition) the modern conception of value-in-exchange began to take form; it was purchasing power, and goods were seen to have value not absolutely, but in relation to each other. An absolute value, however, still persisted under the name of intrinsic value.

Thinkers during this period naturally directed their attention almost exclusively to phenomena connected with commerce, thus value was explained almost entirely from conditions of exchange (Sewall 1901). But, and as Sewall (*ibid.*) adds, before the close of the period the disposition to look at economic phenomena as a whole began to be manifest, including a tendency to explain value from the standpoint of production as well as that of exchange. In particular, the idea that prices and profits reflected the conditions of production, rather than the forces of demand, began to gain ground (Screpanti and Zamagni 2005).

The major contribution in this change has been attributed to William Petty (1623–1687). Petty’s explanation of value, while falling within the mercantilist era in terms of timing, was nevertheless radically different from that of the period, and more in keeping with later thinking. According to Petty, the determinants of ‘natural value’ were the costs of production, namely the cost of utilising land and labour (Screpanti and Zamagni 2005). This, of course, contrasts with the utilitarian approaches to value espoused by his mercantilist peers.

Petty’s conception of value, one that John Locke shared, differed from that of Barbon’s in that the former viewed value as objective while the former thought of value primarily as emanating from the mind (Sewall 1901). The former approach is mechanical, with value appearing as a result of a combination of external conditions while the later is psychological, with the source of value being the mind, external conditions affecting value via their effects on the mind (*ibid.*). And as Sewall (*ibid.*) adds, both approaches had existed from the Middle Ages, reflected in the tendency

for some thinkers to look to market conditions and others to utility for the source of value.

In William Petty's work lies the genesis of Karl Marx's labour theory of value, as well as the cost-of-production approaches to value associated with classical scholars, such as Adam Smith and David Ricardo. He is also credited for initiating the notion of rent as a surplus, calculated by subtracting the value of the product obtained from a given piece of land both the yield that would have been obtained without the application of labour and the cost of labour (Screpanti and Zamagni 2005). It was left to David Ricardo to refine this thinking, which ultimately led to the conventional view that land value was residual in character, and to the contemporary residual method of valuation.

Before closing off this discussion on mercantilist approaches to value, it is worthwhile to highlight some thinking which foreshadowed technical aspects of contemporary real estate valuation. Mercantilists were naturally interested in the problem of interest, especially as regards the establishment of a legal rate. This was frequently approached from the standpoint of the rent of land. William Petty maintained that if there was no doubt concerning the security of a loan, the interest it earns is equivalent to the rent of so much land as the money lent will buy. Thus levels of interest were linked to the value of land and rent.

John Locke, for his part, similarly reasoned that the value of land depended on the income that can be derived from it, and that the value of land and its income bore the same relationship to each other as the principal of loan bears to the interest it earns. By this way of reasoning, the value of land could be established by capitalising its rental income in terms of the interest rate. Thus, given a certain rental income, the value of the land will be raised if the interest in terms of which it is capitalised is lowered. This inverse relationship between value of property and interest (yield in today's language) is of course now well known. The principle underlying all this is reflected in the traditional income method of valuation that is widely practiced today.

The problem of rent was also dealt with in connection with the value of land itself. Petty was apparently unaware that the value of land was related to the rate of interest. Thus instead of capitalising the return in term of the rate of interest, he suggested that the purchase price that will be paid for land depends on the number of years a prospective purchaser and his immediate descendants are likely to enjoy the rent. Petty estimates that three generations of males may be expected to live concurrently for 21 years, and the value of land was therefore equal to that number times its annual rent. This is probably the origin of the concept of "Years Purchase" in the traditional income method of valuation.

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## Physiocracy

A revolt against mercantilism with its emphasis on balance of trade, wealth, power and frequent wars took place in France, led by 'physiocrats' (Ring and Boykin 1986). The main exponents of the physiocratic school were Richard Cantillon

(1680, circa-1734) and Francois Quesnay (1694–1774). The physiocratic period has been dated from 1756, when Quesnay's *Grande Encyclopedie* was published, to 1776 when Adam Smith published his *Wealth of Nations* (Brue and Grant 2007). The mercantilist ethos of promoting national prosperity by means of trade had resulted in high taxes and strict regulation of commerce and industry, which in France had a catastrophic effect on agriculture. The Physiocratic School placed emphasis on agricultural productivity (rather than trade) and advocated for free markets (*laissez-faire*), a revolutionary idea in a period where excessive Government regulation of economic activity was the norm (*ibid.*).

Three tenets of physiocratic doctrine are worth mentioning (Screpanti and Zamagni 2005): first, new concepts of productive and unproductive labour which were introduced in connection with a new concept of wealth; a concept by which the real source of wealth is the *net product* obtained by applying labour to land, and not trade; second, the idea of interdependence among the various productive processes and the related idea of macroeconomic equilibrium; and finally the representation of the economic exchanges as a circular flow of money and goods among the various economic sectors. The physiocrats are said to be the world's first macroeconomists (*ibid.*).

The fundamental economic postulate of the physiocrats was that cultivation of land was the sole source of new wealth (Sewall 1901) (and, by extension, value). This in direct contrast with the views of Locke and Petty who regarded industrial labour, alongside agricultural labour, as the source of wealth (*ibid.*). The Physiocrats argued that value was based on utility or usefulness. The Physiocrats, therefore, did not regard value as intrinsic or inherent in things (Ring and Boykin 1986). Further they viewed the concepts of price and value as interchangeable (*ibid.*).

Cantillon regarded value as fundamentally a relation in which things stood in relation to the cost required to produce them (Sewall 1901). While Cantillon held the view that price and cost (i.e. value) were interchangeable, he recognised that the two might on occasion diverge. Quesnay, for his part, is credited for making the distinction between value-in-use and value-in exchange (Sewall 1901). He discussed value from both the point of view of exchange and that of production. Regarding the determination of exchange value, he appears to downplay the role of personal preferences, while emphasizing that of relative scarcity and market competition. Quesnay attributed value to the cost of labour that went into making the product. This cost was in turn measured by reference to the amount required to provide subsistence to that labour in the making of the product (*ibid.*).

In summary, the physiocratic approach conceived cost as the ultimate cause and measure of value. The physiocrats, however, were unable to properly appreciate the role of utility in the determination of value. The task of developing and refining utilitarian conceptions of value was left to later thinkers, and to the Marginal Utility School (to be discussed later in this chapter).

## The Classical School

The classical school is widely regarded as the first modern school of economic thought, with Adam Smith's *The Wealth of Nations*, published in 1776, frequently referred to as the first economics textbook. In addition to Smith (1721–1790), other distinguished thinkers associated with the classical school included David Ricardo (1772–1823), Thomas Malthus (1776–1834), Jean Baptiste Say (1767–1832) and John Stuart Mill (1806–1873).

The social context of this period was characterized by the emergence of capitalism in Europe, associated with the industrial revolution, and the concomitant waning of feudalism. These changes raised questions about how society should be organized in a context where individuals' profit incentive was becoming increasingly important. Classical economists attempted to reorient economics away from the interests of the ruling class to that of society as a whole.

The general sentiment was that self-regulating free markets (Adam Smith's 'invisible hand') would automatically bring about the maximum good for society. The classical school is thus alternatively described as the period of laissez-faire economics. The doctrine of laissez-faire economics was heavily influenced by the scientific revolution and the search for 'natural laws' by which the economic system and society would be guided. The scientific revolution, principally Newtonian mechanics, popularised the idea that the universe was governed by natural laws (Brue and Grant 2007).

To the classical scholars, natural law implied individual freedom, and that society would be best served if people were left to pursue their self-interest (Brue and Grant 2007). Classical economics rationalised the practices being engaged in by enterprising people. It justified the overthrow of mercantilist restrictions. In an era where competition was a growing phenomenon, reliance upon it as the great regulator of the economy was a tenable viewpoint (*ibid.*).

Brue and Grant (2007, p. 47) summarise the major tenets of the classical school as follows:

- Minimal government involvement—the economy was held to be self-adjusting and tending towards full employment without government intervention.
- Self-interested economic behavior—this was assumed to be an innate attribute of human nature.
- Harmony of interests—by pursuing their own individual interests, it was held that people served the best interests of society.
- Importance of all economic resources and activities—land, labour, capital and enterprise, as well as agriculture, commerce, production and international exchange were seen to all contribute to a nation's wealth. This in contrast to the mercantilists' focus on commerce and that of the physiocrats on land and agriculture.
- Economic laws—the classical scholars made a tremendous contribution to the economics discipline by attempting to develop explicit economic theories or laws, such as the law of comparative advantage, the law of diminishing returns

and the Ricardian theory of rent. They believed that these laws were universal and immutable.

In these tenets of the classical school is to be found the genesis of the key assumptions of neoclassical economics, namely, rational choice, competitive markets and market equilibrium. The attempt to develop economic laws *qua* physics was the beginning of the attempt to mould economics into a scientific discipline, and ultimately gave mainstream economics its positivist methodology.

The key contributors to value theory in the classical school were Adam Smith and David Ricardo. In the *Wealth of Nations* (1776), the first treatment of economics, Adam Smith postulated that value was created when the factors of production (capital, land and labour) were brought together to produce a useful item. He considered value as an objective phenomenon. By virtue of its existence, an item was assumed to possess utility. The 'natural price' of an object generally reflected how much the item cost to produce.

Adam Smith is credited for clarifying the distinctions between 'value in use' and 'value in exchange' and between 'market value' and 'market price' (Brue and Grant 2007; Ring and Boykin 1986). Smith demonstrated that only when the utility of a good was accompanied by scarcity and demand could market value arise (Ring and Boykin, *ibid.*). Further, he argued that the cost of production determined a good's exchange value. Demand, according to Smith, did not influence the value of commodities, rather the cost of production, namely, wages, rent, and profits were the only determinants of value in the *long run*. His view was that competition would drive down prices to costs, including a normal profit and any increase in demand would not increase value, because the cost of producing each unit of the commodity remain unchanged at all production levels. Smith was not aware of the problem of increasing marginal cost.

Regarding the distinction between market price and 'natural price' (i.e. market value), Smith viewed the former as the actual price of a good at a given moment and the latter as that which would allow the payment of workers, capitalists and landowners at normal rates of compensation (Screpanti and Zamagni 2005). According to Smith, the market price depended on the interaction of supply and demand in the short-run. This price may be above, below or exactly the same as the natural price. The natural price, on the other hand, was the 'central price' towards which the prices of all goods gravitated on account of competitive pressures (*ibid.*). It was the long-run price below which entrepreneurs no longer would continue to sell their goods (Brue and Grant 2007). Smith argued that neither the short-run nor demand were fundamental determinants of market value, but instead simply caused fluctuations in market prices around the natural prices of commodities (*ibid.*).

Smith made a significant contribution to value theory. His ideas, as the above discussion shows, are both a precursor to neoclassical theory and recognisably modern. Smith did not, however, manage to formulate a completely successful theory of value (Screpanti and Zamagni 2005). In particular he failed to solve the so-called paradox of value, as in why, for example, water, which is imminently useful, is less valuable than diamonds. This had to wait for later economists who

could see the distinction between a good's total utility and its marginal utility (Brue and Grant 2007).

David Ricardo's most significant contribution to the development of value thought is his theory of rent. This theory is the foundation of the modern residual theory of land value. Ricardo developed a theory that, in the long run, land rents (and therefore land prices and value) depended on the cost of production, but at the marginal point where the last and poorest land was brought into cultivation (Ring and Boykin 1986). On this marginal land, on which no rent was payable, the price of the product exactly equalled the cost of labour and capital (*ibid.*). His theory was that any surplus way and above the cost of production (including normal profit) required to bring land into cultivation would accrue to landowners as rent (*ibid.*). This is the principal on which the modern residual method of valuation is based.

According to Brue and Grant (2007) Ricardo was the first economist to formulate a marginal principal in economic analysis, with his theory of rent seminal to the later rise of the marginalist school. In addition to being the father of the residual approach to land value, Ricardo's theory contributed significantly to the concept of highest and best use that underlies contemporary thinking about market value.

Unlike Smith, Ricardo was primarily concerned with relative values (i.e. exchange value), and not absolute value (Brue and Grant 2007). His view was that exchange value, arose from the utility of the commodity. Possessing utility, commodities derived their exchange value from two sources—their scarcity and the quantity of labour required to produce them (*ibid.*). This, of course, is essentially an elaboration of the labour theory of value, which made its first appearance in earlier times and reached its zenith in Marxist doctrine which followed.

Ricardo's views regarding the relationship between market value ('natural price') and market price were Smithian. He argued that although labour was the foundation of the value of commodities, market prices deviated from value or natural price because of temporary fluctuations of supply and demand (Brue and Grant 2007). He recognized that market prices deviated from natural prices in the short-run, but that the actions of individuals seeking maximum advantage tended to keep market prices proportional to values in the long run. Short-run prices depended on supply and demand, but long run values depended on the costs of production, of which labour costs were the most salient (*ibid.*). In the long run, according to Ricardo, demand had no role in the determination of value.

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## The Austrian (Marginal Utility) School

The term 'marginalist revolution' refers to the nearly simultaneous, but completely independent, discovery in the early 1870s, by Stanley Jevons (1835–1882), Carl Menger (1840–1925) and Leon Walras (1834–1910), of the principle of diminishing marginal utility as the fundamental building block of a new microeconomics (Blaug 1986). Significantly, for our purposes, is that the first economic theory to be revolutionised by this discovery was the theory of value. The prevailing

orthodoxy, from classical economics, was that exchange value was determined by the cost of production, especially labour costs. Exchange value was held to be entirely objective, since production costs could be determined with some accuracy and were independent of individual preferences.

Marginalists substituted the 'cost-of production' theory of valuer with a theory of value based on marginal utility, in terms of which value was linked value to the utility of, and demand for, the marginal unit of an item. Classical economics was devoid of a theory of demand and, therefore, an asymmetrical theory of price determination (Blaug 1986). The marginalists repudiated the cost approach to value by arguing that if one more unit than is needed or demanded appears in a given market, the market became diluted and the cost of production became irrelevant. The marginalists therefore, regarded value as a function of demand, with utility as its fundamental precept.

The major tenets of the marginalist school, building on classical economic theory, while serving as precursors to neoclassical economic theory, are as follows (Brue and Grant 2007, p. 212)

- Focus on the margin in economic analysis.
- Assumption of rational economic behaviour, or utility maximization, on the part of economic agents.
- Microeconomic emphasis, with individuals and firms taking the analytical centre stage (i.e. the concept of methodological individualism).
- The use of the abstract deductive method.
- Emphasis on pure competition, the forerunner of the neoclassical construct of the perfect market.
- A demand oriented price theory, with demand the primary force in price determination, in contrast with the cost of production (or supply orientation) of the classical school.
- Emphasis on subjective utility, which is a subjective psychological phenomenon.
- Equilibrium approach, with economic forces held as tending towards equilibrium.
- Minimal government involvement.

In a direct challenge to the classical school, which as we have seen conceived value to be determined by the cost of production, William Jevons held the view that value depended entirely on utility (Brue and Grant 2007). Jevons considered utility not as an intrinsic quality of an object but as the sum of pleasures its use allows (Screpanti and Zamagni 2005). Jevons argued that labour costs determined value only in an indirect manner, by varying the degree of utility of the commodity through an increase or limitation of supply (Brue and Grant 2007; Backhouse 2002).

Jevon's value theory was based on the now well-known law of diminishing marginal utility. The concept of marginal utility links value to the utility, and demand for, the marginal unit of an item. The law of marginal utility solved the



paradox regarding the relative value of water and diamonds that had puzzled some of the classical economists. The principal of diminishing marginal utility reveals that whereas the total utility of water is greater than the total utility of diamonds, the marginal utility of the later is far greater than of the former (Brue and Grant 2007). Hence diamonds tend to have higher exchange value.

Carl Menger is said to have been the first economist to consider the problem of putting a value on the factors of production on the basis of their contribution to the total value of their products (Rima 1986). Like Jevons, Menger based his theory of value on the concept of utility. But, unlike Jevons, he equated exchange value with total, not marginal, utility. If the classical economists considered value to be essentially governed by past costs, Menger considered it to be an expression of the *judgement* of the consumer in regard to the goods suitable to satisfy his needs (Screpanti and Zamagni 2005). Value, according to Menger, had nothing to do with the cost of production. He held that both the nature and the measure of value was entirely subjective, and depended on preferences of individuals concerned, and income available to each (Brue and Grant 2007).

Leon Walras' principal contribution to economic analysis was his theory of the general economic equilibrium (Screpanti and Zamagni 2005). Walras recognized that the operation of the forces of supply and demand in one market depended on prices established in several other markets (*ibid.*). Equilibrium theory holds that there is a well-articulated set of relationships between prices and quantities exchanged in regard to both inputs and to outputs. This set of relationships is said to be in a state of general equilibrium when the prices and quantities are such that the maximum satisfaction each agent pursues by his own choices is compatible with the maximum satisfaction pursued by all the other agents (*ibid.*). More precisely an economy is in Walrasian competitive equilibrium when there is a set of prices such that (1) in each market the demand equals supply, (2) each agent is able to buy and sell exactly what he planned to do, and (3) all the firms and consumers are able to exchange precisely those quantities of goods which maximize, respectively profits and utilities (*ibid.*).

The central aim of Walras' theory was to show how the voluntary exchanges among individuals who are *well-informed*, *self-interested* and *rational* will lead to an organization of the production and distribution of income which is *efficient and mutually beneficial* (Screpanti and Zamagni 2005, emphasis in original). His ideas were to directly lead to the neoclassical construct of the perfect market, with its assumptions of perfectly informed, rational actors trading perfectly fungible and mobile products or services in impersonal transactions. They provided the basis for the key assumptions of neoclassical economic theory, namely equilibrium, rational choice and perfect information. Price theory, arising from the notion of equilibrium between supply and demand, and on which the conventional concept of market value is based, is itself an outcome of Walrasian thinking.

By way of concluding this section, it is appropriate to flag the important and lasting impact on value theory made by the Austrian School, being the development of the human or psychological (i.e. demand) concept of value (Ring and Boykin 1986). People, it was argued, in the final analysis determine value—not objects or



things (*ibid.*). This view was in direct contrast to the view of classical economists who saw value as arising from the production or supply angle. The shortcomings of the classical school in over-emphasising one extreme—production cost—were, however, overcompensated for by the Austrian school adherents to the other extreme, that of demand. The view that the value of any good was determined by the marginal utility of the last unit required to meet demand irrespective of the cost necessary in its production was the principal weakness of the marginal utility school. This weakness was caused by failure to distinguish the effects on value of both short-run and long-run economic market forces. Utility has a dominant role in determining value in the short-run, but in the long run the cost of production comes into play.

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## The Neoclassical and Equilibrium Schools

The microeconomic thought of the marginalists was gradually transformed into what is now referred to as neoclassical economics (Brue and Grant 2007). In the nineteenth and early twentieth century, the neoclassical school successfully merged the supply-cost considerations of the classicists with the demand-price theory of the marginal utility school (Rima 1986). This body of principles is called neoclassical because it incorporated the insights of the marginal utility theorists while also retaining the classical relevance of the cost of production in the determination of value. According to Brue and Grant (2007) the neoclassical economists were marginalists in the sense that they emphasized decision-making and price determination at the margin. The key difference between them and the Austrian school was that they stressed both demand and supply in the determination of market prices.

Alfred Marshall (1842–1924) is widely regarded as the greatest figure in the neoclassical school and is credited with this synthesis, which forms the basis for the standard theory of market value. He analysed demand and supply separately before combining them to arrive at the idea of equilibrium competitive market price and quantity. In line with the marginal utility school, Marshall conceived demand as based on the law of diminishing marginal utility (Brue and Grant 2007). In addition, he postulated the idea of rational consumer choice which, together with the law of diminishing marginal utility, allowed him to develop his ‘law of demand’—to wit, that ‘the amount demanded increases with a fall in price, and diminishes with a rise in the price’ (*ibid.*). This is the now familiar downward sloping demand function. Regarding supply, Marshall stated that it was governed by the cost of production.

Marshall made a seminal contribution to the development of standard value theory. He addressed the question of what determined market price. As we have seen, the classical economists attributed it to the cost of production while the marginalists attributed it to demand. Marshall’s key contribution was to recognize that both supply and demand were responsible for establishing market prices, with cost lying behind the former and utility lying behind the latter (Brue and Grant 2007). Supply and demand, according to him, were analogous to the blades of a pair

of scissors, because neither concept could be separated from the determination of value.

Crucially, for the exposition of value theory, Marshall divided time into three periods namely the immediate present, the short-run and the long run (Brue and Grant 2007). By this device he was able to clearly articulate the links between price, cost and value. Market prices, according to Marshall, referred to the present, with no time allowed for the adaptation of the quantity supplied to changes in demand. Thus prices in the present were largely a function of demand (i.e. utility). In the short run, defined as the period in which the variable inputs can be increased or decreased, the upward sloping supply curve obtained, implying that the higher the product price, the larger is the quantity supplied. In the long run all costs became variable. If prices rose such that total revenue exceeded the total cost of production, capital would enter the industry and market supply would increase, shifting the entire supply curve to the right. Under these conditions prices would fall towards the cost of production (ibid.). Put differently, the cost of production determined prices in the long run.

Marshall maintained that market forces tended towards equilibrium, where prices and production costs meet. In the long run, a perfect market would form when price, value and cost would all be equal. In the short run, however, with supply relatively fixed, value was a function of demand. More broadly, the now familiar assumptions of methodological individualism, rational choice and equilibrium, whose origins were in marginalist thinking, had become firmly established at the core of the neoclassical school.

Marshall was the first major economist to consider the techniques of valuation, specifically the valuation of real estate. His theories form the basis of the modern sales comparison, the income and the cost methods of valuation, which are reviewed in the following chapter. The neoclassical theoretic approach, of which he was the principle protagonist, is in turn the dominant paradigm in economics, and provides the foundation for much of the contemporary approach towards real estate valuation.

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## Concluding Comments

This chapter has endeavoured to summarise the evolution of ideas relating to economic value. It is impossible to, in a few pages, do full justice to such a complex subject matter, which in essence lies at the heart of economic history. It is hoped however that by truncating the discussion, and highlighting the key ideas associated with each period, the chapter has engendered a credible picture of the development of the theory of value. This relatively short treatment of the subject may perhaps have over-simplified, by exaggerating the differences between the periods and downplaying the nuanced relationships between competing ideas. Its purpose, however, has been to demonstrate the precarious or transitory nature of what may appear, in any period, to be immutable law. Standard real estate value theory should be seen in this light.

It is difficult to properly capture this evolution in summary. However, and as indicated at the beginning of the chapter, this evolution has seen the ascendancy of the concept of exchange value, at the expense of use value, and that of the subjective conception of value, at the expense of the objective conception. This, in turn, is on account of the increased importance of the market mechanism in social life, on one hand, and the increased dominance of science, over superstition and religion, as the basis for the explanation of social phenomena, on the other.

J. S. Mill, writing in *Principles of Political Economy* in the mid nineteenth century declared:

Happily there is nothing in the laws of value which remains for the present or any future writer to clear up; the theory of the subject is complete: the only difficulty to overcome is that of stating it as to solve by anticipation the chief perplexities which occur in applying it.

While the evolution of value theory has been characterized by improved analytical rigour, and greater clarity, granularity and sophistication of exposition, the final chapter has, by no means, been written. Mill's bold declaration notwithstanding, there is much more to be done, both at the level of fundamental theory and at application.

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