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Market Value and Public Value: An Exploratory Essay

Recently, notions of "public value" have been introduced into valuation theory. The premise of one set of theories is that public values in real estate can represent a premium over traditional market value. In another approach, public value is a component of a property's value that should be deducted for some purposes. There are flaws inherent in both concepts, one of which is the impossibility of accurately estimating either form of public value. The authors suggest that traditional market value concepts remain an essential touchstone for efficient and equitable transactions between private parties as well as between private and public parties.

Touchstone: 1. a black siliceous stone related to flint and formerly used to test the purity of gold and silver by the streak left on the stone when rubbed by the metal. 2. a test or criterion for determining the quality or genuineness of a thing.

—Webster's Ninth New Collegiate Dictionary

Real estate appraising has become both a profession and a discipline in the best sense of those terms in the past fifty years. The principal characteristic of a profession is that its members abide by a code of ethics and a set of standards of professional practice. One of the characteristics that makes appraisal a discipline is that its practitioners adhere to a developed set of methods (e.g., sales comparison, income, and cost approaches to value) and carefully structured definitions of a few key concepts. These methods and definitions impose systematic thinking, and therefore discipline, on members of the profession; they are the touchstones of appraisal.

In any profession or discipline there is room for creativity and new

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ideas. Accepted appraisal methods are frequently challenged by the need to respond to new legal concepts, new forms of financing, new insights from the social and natural sciences, and even changes in national and international political and economic systems. But the basic appraisal methods and definitions have shown a remarkable resilience, accommodating these changes while continuing to serve as touchstones of the genuine in the appraisal profession.[1]

In this article, the central definition of market value is analyzed in the context of an emerging tendency on the part of some appraisers and nonappraisers to seek a "public value" in real estate, and then to equate that value with market value. In some cases this has been called "natural value" or "option value" and it has been argued that such a value should be attached as a premium on certain kinds of properties in which the public has or might have an interest—making such properties more valuable than the traditional definition of market value would support. In other cases public value refers to a hypothetical contribution made by public authorities or by neighboring property owners rather than by the individual owner to the market value of a property. In this second usage, traditional market value is higher than either the public or private components and is in effect a combination of the two.

These concepts of public value, while interesting theories that shed light on the nature and origin of the multitude of values that attach to every property, are fundamentally different from the touchstone concept of market value. Efforts to stretch the definition of market value to include public value threaten the definitional foundation on which real estate appraisal as a profession and a discipline is based; more significantly, they threaten to create inequities and inefficiencies in real estate appraisal, in litigation, and in public policy.

THE MARKET VALUE TOUCHSTONE

The cornerstone of appraisal is a consensus among appraisers, the courts, and the public on at least the broad outlines of a definition of market value. As *The Dictionary of Real Estate Appraisal* puts it, market value is "the most probable price in cash, terms equivalent to cash, or in other precisely revealed terms, for which the appraised property will sell in a competitive market under all conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress."[2]

Even with that definition of market value in place, the concept of value is a constant challenge to appraisers of real estate. An appraiser has to make sure that a client understands the difference between the technical definition and a lay person's common perception of the definition. The following aspects of market value are known for certain.

- Market value is an economic concept based on the notion of trading one thing for another according to an agreed-on ele-

1. Consider, for example, the sweeping acceptance of the concept of discounted present value in the income approach to value, or the change in the definition of market value to reflect the most probable price rather than the highest price at which a property will sell.
2. American Inst. of Real Estate Appraisers, *The Dictionary of Real Estate Appraisal* (Chicago: American Inst. of Real Estate Appraisers, 1984), 194–195.

ment of exchange such as money, services, goods, or real estate.

- Market value is not the same as either "price" or "cost."
- Market value assumes that a marketplace exists in which privately owned properties can be traded and that government supports and encourages, but also regulates (and therefore contributes to), the private market and the ownership of property.
- Market value is based on values established in transactions between independent parties, and is the equitable standard for determining value between such parties when voluntary negotiation is not possible.
- Market value is determined by the market, even when it is not possible to precisely define the nature or extent of that market.[3]

Some of the factors that contribute to an individual's perception of the value of a property are intangible. For example, the location of a house can be considered valuable because of proximity to a job, the friendliness of neighbors, or the view of a particular tree from a bedroom window. Unless the marketplace also assigns value to these characteristics, however, they are not part of a property's market value. If a buyer is willing to pay more for such characteristics when other buyers will not, he or she is violating the concepts of prudence on which market value is predicated and is not paying market value.

This notion of market value is foreign to some cultures. Native Americans as well as some other cultures have traditionally resisted concepts of individual ownership of property. Some environmentalists also reject the idea that any part of an ecosystem should be appropriated for the use, no matter how benign, of individual humans or their corporations. One of the central tenets of our civilization and legal system, however, is the notion of individual ownership of real property.

Of course any one of us may choose to put aside the concept of market value for the sake of realizing other goals. We may voluntarily pay more to the market, or demand more from the market, in a trade that involves a property that has special meaning to us. Real estate appraisers deal with such situations by differentiating between price and value and especially between market value and investment value (i.e., value to a particular buyer).

PUBLIC VALUE AS A PREMIUM ON MARKET VALUE

In the past several decades, economists working on natural resource issues have developed several methods—travel-cost analysis and contingent valuation, among others—intended to measure the public value of natural resources when the marketplace does not directly do so. Among the public amenities of natural areas are scenic beauty, wildlife habitat, or active or passive recreational potential. These methods were largely developed to aid government entities in deciding whether to invest in acquisition, protection, or enhancement of natural resource areas. They thus most closely approximate measurement of what appraisers call investment value. In this case, investment value is sought by a federal, state, or local government agency that is trying to decide whether it should be-

3. For one of the best recent articles on market value, see Jared Shlaes, "The Market in Market Value," *The Appraisal Journal* (October 1984): 494.

come an owner of the resource on behalf of the general public.

Although the accuracy of these resource valuation methods has been questioned, their purpose—to improve public investment decision making—is laudable. Unfortunately, several recent attempts have been made to apply these public value concepts to real estate as if they were equivalent to market value. They are not.

One attempt to describe a method for valuing such property is proposed by Victoria Adams and Bill Mundy in "The Valuation of High-Amenity Natural Land." Adams and Mundy reject traditional appraisal methods as inappropriate for the valuation of a category of properties they call natural lands:

> The income capitalization approach, and other methods based on economic analysis, are not generally applicable to the valuation of natural lands. This is because such attributes as old growth or virgin forest, unique wildlife habitats, and other features often cause the public to severely constrain or effectively stop economic use. In such cases, the message of the public is that these lands have a higher and better use than certain economic alternatives. The dilemma appraisers face is how to quantify this noneconomically based value."[4]

This is a false dilemma. Virtually all real estate is constrained by government regulation. Natural land is not unique in this regard. An appraiser, reflecting the marketplace, routinely incorporates such messages of the public in the determination of highest and best use.

Adams and Mundy further argue that the concept of value that most appropriately determines the value of natural land is what some economists call option value. Adams and Mundy discuss the meaning of option value as follows:

> Option value has several related meanings, all of which are relevant in considering the value of scarce natural environments. In one sense, while actual visitors to the site benefit from its being preserved and open to public access, nonusers also benefit because they and their children have acquired the option to visit the site at a later date.
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> From the point of view of land and resource planners, the significance of option value is that they have gained the option to preserve the resource in its present state or develop it later. This is a significant value—since the supply of these resources is limited, additional wilderness lands cannot be artificially produced, and once they have been developed they cannot be returned to their natural state.
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> Finally, from the viewpoint of the seller, option value is the value, in addition to present economic value, which arises from retaining an option to a good or service for which future demand is uncertain. As natural wilderness areas become increasingly scarce, their value to society is increasing. By selling now, the seller gives up the option to sell in the future and possibly realize a significantly higher price. Each of these facets of value shows a benefit gained through the preservation of natural land areas."[5]

Adams and Mundy express the belief, however, that the traditional notion of highest and best use can accommodate this concept of option value:

> The value of property is based on its potential uses. Highest and best use, therefore, is the very cornerstone of the appraisal process. By definition the highest and best

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4. Victoria Adams and Bill Mundy, "The Valuation of High-Amenity Natural Land," *The Appraisal Journal* (January 1991): 48.

5. Ibid., 50.

use of a property will be one that maximizes the net present value derived from the property. Although this has been commonly constructed to mean what could be extracted from or developed on a property, there is a growing acceptance that certain natural land resources may have significant value that can only be realized when retained in a natural (or near natural) state. Given the increasing scarcity of such resources, this undeveloped value may indeed be higher over time, thus maximizing the present value of the property."[6]

Natural land, however, cannot represent the highest and best use of a property, because it fails to satisfy the key criterion that the prospective use of the property be supported by the market. Instead, what Adams and Mundy interpret as highest and best use is merely the intended use of the buyers, typically either government agencies or private or public interest organizations. The mere fact that these public or publicly oriented buyers intend to preserve their acquisitions as natural areas does not create a natural land market. Indeed, both government appraisal standards and the acquisition policies of natural land trusts specifically prohibit those organizations from paying a higher price for a property than would be supported by the property's highest and best use in the private marketplace.

Adams and Mundy express the belief that the sales comparison approach can be used to determine the option value of high-amenity natural land, drawing on "evidence. . . that demonstrates a significant market in undeveloped land with the intent of preserving its natural, scenic, wilderness, or wildlife habitat character."[7]

They cite a purchase of property in the Priboloff Islands off Alaska as evidence of a market in which public agencies pay a premium for natural value. The price authorized by Congress in that instance—eight times the market value—represented, not the workings of a market, but rather a political decision and a possible example of poor public policy judgment.

Though such notions of premiums for natural or public values have only recently appeared in *The Appraisal Journal*, this idea is not new to private landowners who try to maximize the price a government agency will pay for their property. The owner of a historic landmark is wise to try to convince the federal government that the property will have much more value as part of a string of nationally promoted sites than it has ever had as a privately run tourist attraction and that the public ought to pay a premium for this potential. The owner of an ancient and rare stand of virgin timber is equally wise to suggest to a potential public buyer that the property's value to the public as perpetually preserved wilderness is many times more than its value as harvestable timber in the private market.

There is nothing wrong with such assertions of special value; they are a normal part of a transaction between a potential seller and a potential buyer. Further, they are not confined to public acquisitions. Private sellers routinely try to convince private buyers that their property has a special worth to that buyer, just as private buyers try to convince private sellers of the special disadvantages of property that they are trying to buy. A problem occurs, however, when appraisers misinterpret the intended use or value to one side of the transaction as representative of a whole new

6. Ibid., 51.

7. Ibid.

market—in this case, a public or natural land market.

PUBLIC VALUE AS A COMPONENT OF MARKET VALUE

Market value can be increased or decreased, created or destroyed. Further, the market value of every property is affected by the activities of many individuals and institutions. The custodial, entrepreneurial, and managerial skills of an owner; the actions of neighbors; and the activities of federal, state, and local government all affect the value of a property. In fact, a properly performed highest and best use analysis is precisely an analysis of all of these factors.

Some have tried to devise methods to separate and segment value into its various components. There have even been a few court cases in the past 20 years that have tried to segment market value into public and private components. This has typically occurred when the legal limits of public regulation of private property—for example, through land use and zoning laws—were being tested in the courts.

For example, in *Penn Central Transportation Company* v. *City of New York*,[8] the highest court in New York differentiated between the public and private components of market value in deciding whether a landmark preservation law denied a property owner all reasonable return on its property. The key issue in the case, according to the court, was "the extent to which government, when regulating private property, must assure what is described as a reasonable return on that ingredient of property value created not so much by the efforts of the property owner, but instead by the accumulated indirect social and direct governmental investment in the physical property, its functions, and its surroundings."[9]

The court concluded that only return on the private component of value needed to be analyzed in the context of deciding whether a land use regulation was valid:

> Although government regulation is invalid if it denies a property owner all reasonable return, there is no constitutional imperative that the return embrace all attributes, incidental influences, or contributing external factors derived from the social complex in which the property rests. So many of these attributes are not the result of private effort or investment but of opportunities for the utilization or exploitation which an organized society offers to any private enterprise, especially to a public utility, favored by government and the public. These, too, constitute a background of massive social and governmental investment in the organized community without which the private enterprise could neither exist nor prosper. . . . It is that privately managed ingredient which is the property on which the reasonable return is to be based. All else is society's contribution by the sweat of its brow and the expenditure of its funds.[10]

The court recognized the difficulties of the segmentation it advocated, noting that "The massive and indistinguishable public, governmental, and private contributions. . . are inseparably joint. . . . It is exceedingly difficult but imperative, nevertheless, to sort out the merged ingredients and to assess the rights and responsibilities of owner and society."[11] In this case

8. *Penn Central Transportation Company* v. *City of New York*, 42 N.Y.2d 324, 366 N.E.2d 1271 (1977).
9. Ibid., 366 N.E.2d at 1272.
10. Ibid., at 1273.
11. Ibid., at 1276.

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the highest court in New York, after analyzing the appropriate segmentation, ruled that there was a reasonable return on the private component of value remaining to the owner even with the landmark ordinance in place.[12]

The public/private value segmentation approach has received little support in jurisdictions other than New York, and has so far been confined primarily to cases that involve land use and zoning decisions. Segmentation theory could apply with equal ease to other types of cases, however—for example, eminent domain cases. In an eminent domain case, the owner of a private property condemned for, say, an expressway, would be entitled to be compensated only for that portion of the value created by his or her efforts or that of the private marketplace, not for the portion of value created by the activities of government or society as a whole.

In addition, in disputes between individuals or corporations concerning the impact of private actions on property values, it may not be appropriate to compensate a private owner of the property for the entire impact on value. Some of the compensation might equitably be transferred to government or to other property owners to the extent that they created the market value of the property.

CRITIQUE OF THE PUBLIC VALUE THEORIES

No one can argue with the fact that the actions of government and society contribute to the market value of property. Moreover, the idea of option value or contingent value is not a new one. It emerges from the longstanding shared belief (and sometimes frustration) in western capitalist societies that not all values and concerns can be accommodated by a market-driven system of transactions between individuals. Money is not the measure of everything. The money paid for a person's services, for an object, or for a property in the marketplace is not the full measure of its worth. Why not then ease up on the traditional reliance on market value and begin to look for ways to incorporate such previously unaccounted for concepts as public value?

The most serious problem with the notion of a definable public value is quite simple—every property has a public value component, and every property has many contingent or option values. All of us have an interest in every privately held property. For example, when you look out of the window of your house you enjoy the view of your neighbor's yard or the color of his house. Your neighbor, however, may lose his job and cut back on his lawn service, or decide to paint his house chartreuse—you hate chartreuse. Should he ask you to quantify in dollars what that view is worth to you and then pay you—and every other person who similarly enjoys the view of his house—for the value you place on that view or aesthetic experience?

But that is precisely what would be necessary if the concept of option value or contingent value were applied in determining the market value of real estate. Such a position would advocate adding to market value a premium based on the imputed value that members of the public associate with the property being analyzed. Further, in many applications of the concept this amount is determined by ask-

12. That case was affirmed by the United States Supreme Court, although the Court does not discuss the segmentation question.

ing individuals (through survey research) to hypothetically hang a price tag on the value to them of, for example, the view of the Grand Canyon, or the loss in value from knowing that an oil spill has occurred in Prince William Sound, Alaska.

The notion of separating public value from market value raises equally impossible complications. Consider for a moment the incredible variety of ways in which our system of government is inextricably part of the forces that create market value: construction of roads, parks and airports; extensions of public utilities such as water and sewer; processes for recording legal documents that affect title; police and fire protection; public hospitals, libraries, and schools; national defense; and the monetary and banking system that forms the basis for the marketplace in real estate. Even government regulation, such as laws for the protection of the environment or for zoning and planning, protect us from the ill-advised activities of others in the marketplace and thus can have a beneficial effect on the market value of real estate.

Precise segmentation of the private and public contributions to value of property is, as the New York Court of Appeals recognized in the *Penn Central* case, "exceedingly difficult." We would go further, to suggest that it is virtually impossible to accomplish with any degree of accuracy.

Under these two public value approaches, nothing is worth what the market says it is. The touchstone of the genuine market value is gone. All of us have interests in other people's farms, forests, and orchards. Buildings or even non-real estate such as paintings or furniture can have option value, or can have a public as well as a private component of value.

There is no precedent, and there is clearly no equity, in actuating those values, other than through such laws and statutes as environmental regulations, land use laws, and community appearance and design standards. Sometimes a community can claim interests in the property of individuals. A community may decide that a private structure has public significance. It can exercise its interest by regulating the owner's use of the property, prohibiting demolition, or ultimately by exercising eminent domain, with compensation.

The infinite number of potential interests that any one person or government unit may have creates other problems for real-world application of this approach. This issue is especially critical in determining the price that should be paid by government to acquire property, or in determining damages that should be paid in litigation to decide the impact of public or private actions on property value. There is no scientific way to derive precise formulations of these values. The only way to approach this type of problem is to make the policy arguments before an impartial tribunal, for example a jury, and abide by its decision. But in the absence of a touchstone such as the accepted procedures for determining market value, the results are likely to be as arbitrary and subjective as jury awards for pain and suffering in personal injury litigation.

Some say that option value can be determined simply by asking people through statistically appropriate public surveys what a particular amenity is worth to them. People who are educated about an amenity, however, are likely to say that it has value to them, as long as they will not actually have to pay anything for it. Things people know about have more value to them than equally attractive things about which they know nothing.

Consider also the inherent contradiction in the fact that while many are vehemently (and sometimes violently) opposed to increasing taxes, when polled by particular constituencies the same people strongly support spending more money for everything from education to prisons to public health to environmental cleanup. To truly predict contingent value, individuals must be presented with the complete menu of options on which to spend, and a complete budget of the funds available to be spent so that they can allocate limited resources in an informed and rational manner. Such a process is impossible.

There is no single answer to the questions: What is the option value of this property? What proportion of the market value of this property is contributed by government activity? Each combination of alternatives for fund expenditures as well as each different group or area surveyed produces different answers to these questions.

For policy purposes, there may be some logic in confining the set of affected individuals to a particular political jurisdiction. But if this is done, a legitimate complaint may be that the locals do not represent true contingent value. Consider for example the possibility that the majority of the citizens of Alaska might favor opening the Alaska National Wildlife Refuge to oil exploration, while the majority of the residents of the United States might oppose this. Whose natural land is it?

Finally, the sales comparison approach will never be an accurate method for determining option value, contingent value, or public value in real estate situations. Purchases of other property by federal, state, or local government are usually governed by political considerations not truly related to contingent value or option value.

THE TEMPTATION OF PUBLIC VALUE

The temptation to introduce the concept of public value into the way we think about real property is understandable. Advocates of natural resource preservation in particular may hope that by valuing lands based on these broader definitions rather than on the narrow strictures of market value, it will be easier to recognize their importance and advocate their future protection.

There is a potential danger in this logic, however. If the public or natural value of natural lands is estimated to be substantially higher than their market value, the amount of natural land that can be protected through acquisition will be reduced. It will become prohibitively expensive for government units or nonprofit resource preservation organizations to purchase significant natural lands.

Growth management advocates, preservationists, and many local government officials might also be tempted to segment market value into its public and private components as a way of assuring that more land use regulations will be upheld against claims that they unconstitutionally deprive an owner of all reasonable use of or return from his or her property. But if we turn away from market value in the land use arena and segment property into private and public components, do we not also have to do so in the eminent domain arena? Further, once market value is rejected as the touchstone in those two areas, would it be fair to continue to use it as the basis for local property tax assessments? Or should property owners only be taxed on the basis of the private component of value?

CONCLUSION

Analysis of the meaning of public value may be helpful in making informed public decisions. In this regard, it is an adjunct to the cost/benefit studies that have become institutionalized in public—as well as some private—internal decision making. There is no evidence, however, that such concepts represent a substitute for the market in setting levels of acceptable exchange among the private individuals who make up the real estate marketplace. Benefit/cost analysis is a far different undertaking than valuation for purposes of exchange.

There is no such thing as one readily definable contingent value, option value, or natural value. This is in fact merely an attempt to create a single concept of value out of a nearly infinite set of nonmarket values that people have always had, but which we have declined to accept as an effective and efficient basis for transactions between individuals, or between citizens and their government.

The concept of natural value may appear fair. It may seem to allow us to take into consideration important issues. Several decades of sincere and arduous effort on the part of notable economists have failed to make it more than a fiction, however. Natural land value is an unnatural concept.

It is not merely that it is an artificial academic construct. It is not merely that it does not capture the real values that are placed on commodities, including real estate. It is that the concept if applied to real estate would have the effect of making important efforts to preserve natural lands more difficult, and in some cases impossible.

It is essential to hold firm to the practice of dealing with a value based on transactions—for purposes that include public acquisitions and the settlement of disputes in equity between private parties. It is important to remember that when appraisers talk about value in courts or in laws, they are consciously referring to transaction value. The following tests must be adhered to.

- There should be no layering of different concepts of value; one consistent concept of market value should be used.
- The value of theoretical rights that have no legal or economic foundation should not be counted.
- The system of values must be objectively quantifiable, workable, and equitable for all parties.
- The system should work in all directions. Market value to all parties should be the same regardless of who owns a property at a given time.
- The system should involve values that can be universally accepted as a basis for exchange in all situations.

If economics is defined, in part, as the way real people interact in the exchange of goods, it is clear that public value is not an economic concept.[13] While it may be a tool for public decision-making or to help sort out relative preferences for protection among a limited group of alternative resources, it is not economics. It can

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13. There may be another type of public value not addressed here. For example, the public sector may be willing to pay a price for a property based on the ability of that property to generate income to a particular government organization or to avoid expensive or protracted litigation. This may or may not be equivalent to market value, and in some cases may be closer to the traditional definition of investment value.

therefore have no value in the exchange of goods or in determining compensation for damage to real estate among private parties.

Compensation may be made in dollars for noneconomic losses. It is done all the time in tort litigation when juries are allowed to estimate an appropriate award for pain and suffering. This is not appropriate in the valuation of real estate, however, which is an economic commodity both in law and in practice. The valuation of tangible real estate should be clearly separated from the valuation of intangibles such as option value—appraisers make that distinction all the time when they value such properties as hotels or fast food restaurants that have business or franchise value quite different from their real estate value.

It is one of an appraiser's responsibilities to be vigilant in defending the concept of market value. Value is a term that can be loosely used by others; but the basis of our profession is a degree of certainty and, to the extent possible, precision in the definition of what is being determined. Market value is the only true touchstone that offers a systematic and predictable way to quantify matters in which real estate values are central.