

## **Overview**

With this chapter we end our journey into the basics of economics underlying real estate appraisal. We close by covering some terms that link (and occasionally confuse) appraisal and Economics. Then, we conduct a brief tour of the highlights of the course in order to identify some take-away concepts.

## **Objectives**

- Define and understand terms that link Economics and appraisal
- Review the highlights of the course to this point

## Chapter 5: The Languages of Economics and Appraisal

In this section we revisit some terms from earlier in the course and seek to clarify both the terms as well as the links to appraisal.

A model is a simplified view of the world created to solve some more basic problem. *Ceterus parabus*, is the useful Latin phrase (all other things being equal) employed to cover the simplifying assumptions necessary in modeling. Assumptions are everywhere in economic analysis.

In appraisal assumptions take two different forms. These are hypothetical conditions (which is a kind of assumption from an economic viewpoint) and extraordinary assumptions. A hypothetical condition, according to USPAP, is “that which is contrary to what exists but is supposed for the purpose of the analysis.” This commonly occurs in appraisal of new construction. The subject is assumed to be completed as of the current date of the appraisal.

An extraordinary assumption, according to USPAP, is “an assumption, directly related to a specific assignment, which, if found to be false could alter the appraiser’s opinions or conclusions.” The two appraisal terms are often confused even by seasoned appraisers.

Let’s try to clarify the difference. A false condition that the appraiser assumes to be true on the effective date of the appraisal assignment is a hypothetical condition. We assume a new home has already been built in deriving the opinion of market value. On the other hand, if on the effective date the condition in question is unknown and it is reasonable to believe that the condition is true, then it is an extraordinary assumption. For example, it is an extraordinary assumption to assume a property is free of leaking underground storage tanks. You are not assuming it to be false (which would be a hypothetical condition), rather it is probably true.

## Substitutes in Economics and Substitution in Appraisal

We have used the concept of substitution in three different places in the course. The first was in the discussion of elasticity of demand. If there are few substitutes for a given product, demand for the product will be more inelastic. The second was in the context of demand shift and a substitute good that competes with the one under consideration. As the price of a substitute good goes up, the demand for the good under consideration also goes up.

The third mention of substitutes was on the supply side. Here the substitute is a substitute for the seller; it is a different good also produced by that seller. As the price of a substitute for the seller goes up, the seller will supply less of the good under consideration.

In appraisal substitution is known as the principle of substitution. You can see how similar it is to its use in the demand context in our course.

The principle of substitution says that the price someone will pay for a property is influenced by the cost of acquiring a comparable, substitute property. For example, if the list price for a home is \$400,000 but a quite similar property across the street is only \$350,000, it is unlikely the first property would receive a \$400,000 offer. This is the heart of the sales comparison approach to value.

### Revisiting Market Value

We mentioned that market value as used in the appraisal context is an opinion and a probability. Economists rarely use the term in this narrow way. Economists prefer the term market *price* and specifically mean it as the result of the market mechanism. In appraisal, price is usually asking price or closing price and occasionally market price. But market value is reserved for the result of the appraisal assignment.

## **Review of the Course: Some Take-away Concepts**

This section will distill the previous chapters with the concepts you can take out into your appraisal practice. It is hoped that these paragraphs will spur your memory as well as form a useful study guide for your final exam.

Appraisal falls mainly under the subfield of microeconomics, where supply and demand form the cornerstone of the market system. Yet appraisers should still be aware of macroeconomic indicators such as the unemployment and inflation rates. A major take-away idea from the Econometric section is that appraisers need to be cautious in the use of regression analysis.

The ability to graph data and understand it visually is an important skill and is a useful tool for the appraiser tool kit. Elasticity is more than just a unique word to impress your friends with. It measures the responsiveness of buyers to a change in price. Visually it is identified by the steepness of the demand curve.

Speaking of the demand curve, it is downward-sloping. Consumers want more as price falls. On the other side of the market mechanism, the supply curve is upward-sloping. Sellers want to sell less as price falls. For both, a change in price means movement along the curve. Any other kind of change means the curve itself shifts.

Supply and demand come together to generate an equilibrium condition, a market-clearing price. This rarely occurs for long in the real world. Markets are constantly moving, buffeted by all sorts of non-price determinants. The economy is fluid. As appraisers we understand this since each appraisal is dated, a snapshot of value at a very particular time.

Appraisers deal with markets everyday; appraisal can be viewed as the localized supply and demand of real estate. Appraisers generally have a good grasp of shortages and surpluses which are sellers markets and buyers markets. But it is useful to sharpen that understanding with knowledge of the economics driving the system.

## Summary

Modeling and assumptions have a place in both Economics and appraisal. We teased out how *substitute* was understood in the two disciplines and we reviewed highlights from earlier chapters.