Chapter 1
Basic Economic Principles

As the introduction and forward implied, the global financial crisis and subsequent recession raised some serious questions about the validity of mainstream economics and, in particular, its approach to the integration of financial systems and its unshakable belief in market forces and forecasting. As a result, those influenced by the new approach can be excused from being trained to comprehend elegant algebra or to manipulate large complicated mathematical sets and algorithms. This textbook is simply designed to introduce economics that will help the reader to understand the current business markets and government policies that operate in the real world, with specific reference to decisions to develop, own or invest in property.

As Professor Robert Lucas (2009), was keen to point out in defence of the subject: ‘One thing we are not going to have, now or ever, is a set of models that forecasts sudden falls in the value of financial assets, like the declines that followed the failure of Lehman Brothers in September 2008. This is nothing new. It has been known for more than 40 years and is one of the main implications of the efficient market hypothesis, which states that the price of a financial asset reflects all relevant, generally available information. If an economist had a formula that could reliably forecast crises a week in advance, then that formula would become part of generally available information and prices would fall a week earlier!’

In other words, Professor Lucas highlights that the economic world is far more complex than the physical world, as it is influenced by our beliefs about it, and this information is generally signalled through market prices. He does not seek to demean the discipline – he is aware of its limitations, but respectful of its insights.

As Chapter 3 and others in this text emphasise, market prices incorporate much information, but the intriguing aspect of the analysis is that they do not necessarily convey all information accurately, completely or transparently. There is room for
differences of opinion and different perceptions of an uncertain future, as the art of interpretation and forecasting depends on intuition. Economics cannot be learnt by rote or by following hard and fast rules. It should certainly not be regarded as a narrow mathematical discipline, related solely to a study of costs or valuations that produce definite answers. Indeed, economics is a far broader subject than many anticipate, and an important aim of this chapter is to demonstrate that the core principles continue to influence the work of those engaged in finance, business, real estate and politics.

**Definition of economics**

As Lionel Robbins’s (1932) classic statement captured it in his famous book on the *Nature and Significance of Economic Science* (published more than 80 years ago): ‘Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses’. Thus, entrepreneurs – and that includes property developers – must learn to manage scarce resources. This simple-sounding idea, however, is far more complex than it first appears. Many of the world’s resources are finite, yet people have infinite wants. We are, in effect, faced with a two-pronged problem: at any point in time there is a fixed stock of resources, set against many wants. This problem is formally referred to as **scarcity**. In an attempt to reconcile this problem, economists emphasise that people must make careful choices – choices about what is made, how it is made, and for whom it is made; or, in terms of property, choices about what investments are made, how they may be constructed, and whether they should be developed for rent or purchase.

Intriguingly, the challenges facing the surveying profession have been presented in a similar way. As the Royal Institution of Chartered Surveyors (RICS) points out in their publicity blurb: the world is already overpopulated (growing at a rate of about 240 000 people a day) and everyone needs to be fed and housed – yet the earth’s resources are not infinite! According to the RICS, part of the solution to scarcity lies in the sustainable use of land and maximising the long term value of all kinds of property. Therefore, they highlight that the choices we make affect not only how we live today, but how others will live in the future.

What determines these choices are financial rewards, as every resource has an alternative use and, therefore, an alternative source of income. As economists like to emphasise, choosing one thing inevitably requires giving up something else. In making a choice, an alternative opportunity is missed. To highlight this dilemma, economists refer to the concept of **opportunity cost** – where the value of the foregone alternative becomes the focus of the decision. In other words, economics emphasises how every want that ends up being satisfied results in some other want, or wants, remaining unsatisfied.

To take a simple example, if a specific plot of land is used for residential purposes, it cannot also be used as farmland. This means that an important part of understanding property in an economic context involves recognising that we have to decide on the alternative uses made of the fixed amount of land available. This choice is informed by the level of returns paid and the risks involved. Unfortunately, social and environmental returns, and the greater wider good, are often overlooked.
In a nutshell, a key objective of economics is about achieving economic efficiency for the benefit of the greater good – or, to use a commonly quoted nautical metaphor, first used by John F Kennedy more than 50 years ago – to raise the tide that lifts all boats. The Great Recession, however, complicated this straightforward idea as the economy ebbed towards lower levels of economic activity and greater numbers of unemployed. By 2015, serious ethical and political questions ruled the day, such as: should we continue to allow self-interest and self-regulation to allocate resources; or should we recognise that social justice requires that we put an end to society’s excessive greed for profit and growth? Part of the new thinking highlighted that we cannot all be flooded with money at the same time. Extending the analogy the impact of the great recession has been somewhat selective – lifting a few gorgeous yachts, but leaving many smaller boats struggling to stay afloat.

To express the same sentiment in a political guise: to what extent should the taxpayer be expected to fund spending on public services, particularly those that effect the welfare of the typical man in the street? These dilemmas are currently being played out in all sectors of the economy and are exemplified by policy debates relating to the size of the state, and in resource decisions relating to property and housing. In terms of new economic thinking, an over-reliance on efficient markets and rational expectations should be avoided. As Kaletsky (2010: 181) pointed out: ‘The dream of creating a market system with no economic role for government ended on September 15, 2008’.

To sum up, then, about what constitutes the subject matter of economics. It appears that it emerges from questions about money, consumption, work, technology, markets, government policies – and, in the broadest sense, how things are produced. Sometimes there is also a concern about the ways that the incomes generated are distributed, although this has been largely overlooked for the last 200 years, since the work of David Ricardo.

Finally, to close this introductory section, it should be remembered that by defining economics in terms of its core principles, or subject matter, we are avoiding the debate about a preferred methodology. Remember, all we are trying to achieve is insight into a complex machine with many moving parts; we are not seeking universal truths or constant proof.

**Resources (or factors of production)**

Resources can be defined as the inputs used in the production of those things that we desire. Economists tend to refer to these resources as **factors of production**, to emphasise that, to produce any good or service, various factors need to be combined. Therefore, the total quantity, or stock, of resources that an economy has determines what can be produced. To construct real estate, for example, labour is required to develop a plot of land, and plant and equipment, which may be hired or bought, is required to facilitate the process. To put it another way, land and labour are always combined with manufactured resources to produce the things that are demanded.

When introducing property economics to groups of students, I often ask them to pause for thought and think of anything that can be produced without the
involvement of these factors. The most common responses relate to ideas, thoughts, and decisions, and these answers enable me to distinguish economics from philosophy, psychology and business. The most intriguing answers to the question are suggestions relating to some ‘virtual’ activity based on digital technology – but these clearly still require people, equipment and a location to function from. In economic terms, they depend, like all economic goods, on using land, labour and capital to exist.

For property economists, these technology-based activities are actually most interesting, as they change the nature of demand for real estate. Nowadays, the conventional High Street retailer competes with online sales from stocks held in huge warehouses; businesses increasingly outsource activities to call centres; and financial transactions are mostly completed electronically via the internet, a mobile phone or a tablet computer. The development of the so-called new economy does not change the basic economic problem of allocating limited resources between competing ends – but, as we explain, particularly in Chapters 3 and 8, it does change the nature of markets and the nature of employment.

Natural resources

Land is the natural resource we think of most often, and the production of any good or service is dependent on its existence; property is a prime example, as obviously each unit requires a ‘site’ or a ‘location’ (and the requisite planning permission). To date, however, there has been a limited economic analysis of the supply of land as, in a purely theoretical sense, it is ultimately fixed in supply and completely immobile (rural land cannot get up and move to seek better opportunities in urban areas). Land exists regardless of financial reward; its earnings are determined entirely by demand!

In the jargon of economics, the quantity of present and future available supply is completely inelastic with respect to price. This has several economic implications; to take one current example, over the years London has experienced continual growth and the demands for property has increased, to the extent that more and more development is now going on underground. For instance, during 2013, 3000 applications were made for basements (Allen, 2013). In short, economic change has created new patterns of demand for land use in London – but the actual amount of land has not changed.

The urban centres of China are undergoing similar pressure, as a period of unprecedented growth rapidly increases the demands for property in cities such as Beijing and Shanghai. Again, economic change has created new patterns of demand for land use and property in China – but the actual amount of Chinese land has not changed. Similarly, pressures of demand for retail premises on Fifth Avenue near Central Park in New York account for the astronomic levels of rent in the area. For example, in June 2015, it was reported that tenants were paying in the region of $3,500 per square foot – to reiterate, £2,250 for one square foot of sales floor (i.e. £24,300 per square metre) – making it the most expensive retail space in the world.

In the long run, which may be defined as the period of time that firms need to adjust to price changes, it is the level of rent that signals changes to land use.
In effect, rent (or price) allocates the use of land between buildings and other uses. It identifies what becomes used for transport infrastructure, for agriculture, for commercial and residential use, and so on. As with every resource bought and sold in competitive markets, the highest reward determines its current use. In other words, the value of land is derived from its end use; the higher the value, the higher the rent.

For example, some land is extremely fertile and commands its best value when used for agriculture, while other land is incapable of growing anything in its natural state, and reaps far more value as development land. In other instances, the planning legislation may act as a constraint – especially in Britain, where the town and country planners proceed from a premise that much of the nation’s land should be protected from development and retained as ‘Green Belt’.

Of all the factors of production, parcels of land and their location is of key importance, and students of this text should not be misled by those traditional economists who regard land markets to be of secondary importance, on the basis that its quality and quantity are relatively fixed! This is part of the intrigue of the economics of real estate. Land cannot simply transfer to Luxembourg for tax reasons.

Indeed, the limited supply of land presents an interesting dynamic to the property world, and this is added to by central and local government planning policy that specifies what can be built and where. It certainly explains the problem of securing affordable accommodation, and leads to high-density living in many parts of the world. The continual demands made on a nation’s fixed stock of land lead to continual price rises, and this in turn can have a negative impact on the quality and size of built structures. Interestingly, a UK government report, set up to examine how the supply of new homes is influenced by the nature and structure of the building industry, concluded that after the cost of land is taken into account, ‘the returns to housebuilders for investing in quality barely justify the effort’ (Callcutt, 2007: 8).

In other words, in order to maintain profit margins, builders will try to squeeze all other areas of their product, reducing spend on design, putting pressure on input costs, and trying to minimise the amount of land that is used (by maximising densities). The result is a string of disparaging remarks that refer to ‘shoe box Britain’ (RIBA, 2011), where people live in ‘rabbit hutches on plots the size of postage stamps’ (Evans, 1991), in ‘identikit houses designed at Lego land’ (Shapps, 2011).

**Human resources**

In order to produce anything, a human resource must be used. That human resource consists of the productive contributions of labour made by individuals who work, such as architects, estate agents, project managers, surveyors and construction workers. Whenever labour acquires training, the potential contribution to productive output increases; in other words, there is an improvement in human capital. A relevant example is the effect that good trained management can have on the efficiency of a whole project. Finally, there is another type of human resource; namely, entrepreneurial ability.
The entrepreneur is associated with the founding of new businesses, or the introduction of new products and techniques. However, it means more than that. It also encompasses taking risks (possibly losing large sums of wealth on new ventures), inventing new methods of making existing goods, and generally experimenting with any type of new thinking that could lead to a monetary benefit. Without entrepreneurs, businesses would find it difficult to survive and property would not be developed. The entrepreneur is a scarce human resource, as not everyone is willing to take risks or has the ability to make successful business decisions.

Interestingly, over the past 10 or 20 years, there have been a significant number of academic papers analysing how the demand for human resources has changed due to advances in information and communication technology (ICT). The literature reviews the remarkable innovations that technology, the World Wide Web and intelligent machines can deliver, and raises the debate on whether the digital revolution will cause a mass destruction or creation of jobs. In the early part of the 21st Century, as we experience the outcomes of the first wave of these developments, it seems that the digital revolution has opened up a significant divide between skilled and less skilled labour. It appears that the demand for creative and abstract thinkers has increased for a fortunate minority, while many others are left relatively underemployed and poorly paid, carrying out menial, routine, and manual tasks. A further consequence of ICT, therefore, is its association with a widening inequality of income and wealth, and this is another core principal that needs to be considered in an economics course in a post-crisis world. Hence, inequality is discussed further in the food for thought section at the close of this chapter.

Manufactured resources

When any form of labour or entrepreneurial skill is applied to land for agricultural or development purposes, something else is used. It may be a plough, a tractor or a cement mixer. In short, land and labour are always combined with manufactured resources to produce the things that are in demand. In the neoclassical approach, the term ‘capital’ is, in fact, solely dedicated to mechanical or physical items that can be paired with labour. This notion of capital supports the use of a ‘production function’ (a mathematical ratio) that links the respective output of each factor. In textbook language, therefore, manufactured resources are usually referred to as capital, and include things such as machines, buildings and tools.

A problem with this standard presentation of factor resources is that each unit of capital and labour (and land when it is discussed) tend to be treated as equal. Obviously, this is far too simple, as each unit of capital or labour has unique qualities, so they should not be discussed as ‘homogeneous blobs’. They are certainly not infinitely substitutable from one production process to another, and it seems a sweeping generalisation to simply present each firm as a ‘black box’ that transforms homogenous factors of production into output. Equally, entrepreneurs (the ultimate decision makers composing the firm) are not credited with any real talent or importance in the classic view of production.
Neoclassical economics presents a non-complex view of the world and, in effect, oversimplifies economic reality. To some extent, this weakness justifies the need for specialisms such as real estate economics. It also accounts for the work on productivity that has emerged since the 2008 recession as, during these years, we witnessed more and more labour being successively added to the production process, but economic growth did not increase by anyway near the same proportion – productivity per head actually declined. To express this in UK statistics, 1.8 million new jobs were created between 2011 and 2014, but 75% of these were part-time, and often of a low skilled nature. As a consequence, the increased employment did not generate a proportionate increase in economic activity. This new characteristic of slow growth running alongside improving levels of employment was also experienced in several other countries.

Income and wealth

Strictly speaking, a distinction should be drawn between these two related ideas. Income is a flow concept that is closely associated with annual salaries and wages, whereas wealth is a stock concept, associated with accumulated assets built up over time. Thus, a discussion of the distribution of income is not precisely the same thing as a discussion of the distribution of wealth.

Income changes with output and in some senses, this determines its distribution. The classic economists divided income between the different factors of production and, in many ways, the neoclassical economists that followed them continued with this tradition. Thus, a basic introductory principle is that incomes are distributed between the owners of factors of production – namely, labour generates wages, land owners receive rent, the return to the ownership of capital is interest, and entrepreneurs get profits. Hence, all workers, all landlords and all capitalists are kind of lumped together and, as a general principle, the distribution of income is seen to reflect these broad factor categories – although there is no reason to divide the income between them equally. However, in today’s world, it would make more sense to look beyond these broad categories and understand why rents are higher in some areas than others, and why some jobs are paid better than others.

In fact, the distribution of income is a good example of where the neoclassical approach is questionable. Mainstream economists always trust that the market will determine the correct level of reward for each specific type of factor but, without some central government determining a minimum wage level, making welfare payments and collecting taxation (especially on inherited wealth and high incomes), there could be unacceptable levels of inequality. As Paul Samuelson (2010: 333), the author of the largest selling economic textbook, remarked: ‘Today most high-income countries face the prospect of rising tax burdens to finance health and retirement programs as well as income support for poor families’.

In plain English, governments regard it as some kind of necessary duty to redistribute income in order to keep the market working, maintain welfare, and avoid social unrest. The standard theoretical approach becomes even more worrying when we turn our attention to problems of inequality of wealth.
As stated above, wealth is all about stock, and it can be built up in families, over time, especially if it is allowed to pass freely from one generation to the next. The classic example is land and property that is inherited and forms large family estates. Therefore, do not be confused – stocks of wealth are not just about shares in a company; lots of things can be included as stock. An economist’s definition of wealth would typically fall into two categories: non-human wealth – which would include tangible objects that people own and frequently trade, such as buildings, houses, machinery, land, cars and works of art; and human wealth – which involves the intangible skills, talents, knowledge and initiative that people offer to a nation. The total of human and non-human wealth gives a nation its capital stock (note that the terms ‘wealth’ and ‘capital’ are often used interchangeably).

To sharpen the contrast between these two related concepts, following the financial crisis, the nation’s wealth immediately tumbled in value (whereas incomes hardly budged). In fact, it was recorded that, in general terms, the typical household’s net worth (i.e. its assets minus its debts) plummeted by approximately 12% in 2008. This decline would be largely attributed to the significant fall in house values, as housing wealth makes up approximately 50% of a typical household’s assets.

Recently, another definition of wealth has been introduced into the literature that is derived from an important new treatise on ‘capital’ (Piketty, 2014). This new definition of wealth conflates physical capital equipment with all forms of money. In these new terms, wealth is defined by personal assets such as land, houses, property, stocks and shares and personal savings, but excludes ‘human capital,’ and ‘fixed capital’ (such as machines). The main thrust of Piketty’s research was to estimate the current market value of wealth and identify how it was distributed across the population.

The research by Thomas Piketty (2014) confirmed that wealth is much more unequally distributed than income – so, while a division of society into those who own things and those who work for a living is overly simplistic, it is not totally off-base. In the United States, for example, 5% of households own a majority of the wealth while the bottom 40% has negative wealth due to debts. Piketty (2014) demonstrates that, in rich countries, the growth of incomes is generally between 1–2% a year, while the rate of return on wealth averages about 4–5% a year. Thus, those who draw their income from capital outstrip wage earners. The relevance of this question of inequality is picked up again in the food for thought section at the close of this chapter.

### Investment

In mainstream economic texts, the property sector is not usually referred to. It does, however, represent a major form of investment – directly, as residential or commercial property, and indirectly, via institutional funds and instruments. When companies spend money in this way, it is formally referred to as capital expenditure – and informally as ‘capex’.

From a purely economic perspective, investment refers to additions to productive capacity – activity that makes use of resources today in such a way that they
allow for greater production in the future. For example, when a business puts funds into new equipment or develops a new factory, it is making an investment to increase its capacity in the future.

Following the Great Recession, one of the immediate aims of central banks was to suppress interest rates, in order to encourage all types of investment to increase jobs and economic growth. However, due to uncertainty about demand and the risk of weak returns, capital expenditure fell across the Eurozone and emerging economies. In fact, there appeared to be something of a chicken-and-egg problem. Without a strong global recovery, companies would not spend more but, because they did not spend more, there continued to be no recovery.

Two further bits of jargon used to distinguish between types of investment are ‘net’ and ‘replacement’. Replacement investment corresponds to depreciation, and is determined by the rate at which capital wears out, while net investment represents new additions to capital stock. The former is relatively constant, as it is determined by time, but the latter is related to changes in economic activity.

In terms of property investment, these two categories can be associated with the repair and maintenance of existing property assets, and new additions to property being let or sold for the first time. This distinction is useful, as it serves to explain why the property sector is prone to fluctuate more than other sectors. Investment expenditure on maintenance and repairs will be fairly constant, whereas new additions will be one-offs to support expected changes to overall activity. For example, if a retail or manufacturing group manages £100 million pounds worth of property assets, they may spend each year, say, 5%, on maintenance (£5,000,000). If economic activity in their sector rises, however, they will need both to maintain their existing property and to increase their capacity for sales or manufacture by adding to the stock of property assets.

This example might be easier to understand from the converse position, where economic activity decreases and, as a result, the firm releases or sells some of its property stock; in effect, it can meet the present level of demand with zero property investment. As a consequence, property investment tends to alter with greater amplitude than other sectors. It certainly helps to explain the large swings in capital expenditure that are recorded in national accounts.

From a pure property perspective, it is useful to add one final twist to these traditional economic interpretations of investment to include two distinct types of developer; those who create built environment assets for investment clients, and those who develop property for their own purposes; sometimes distinguished by the phrases investor-developer and trader-developer.

These two terms help to clarify the surveyor’s role in investment decisions, as they confirm a need to understand property assets as a means of generating income flows in the future. In short, investment in property must always be seen as an opportunity cost. This is because the relative returns made on other investments, such as government bonds, company shares or general business activities, might be more profitable. In other words, it is not possible to understand property in isolation; it is essential to recognise that it competes as an investment with other assets. Interactions between property markets and the broader economy are discussed in more detail in Parts B and C.
For the last 20-odd years, a part of my work has been associated with the Estates Gazette (for example, see Myers, 2006). The Estates Gazette is a weekly professional magazine where much of the commercial property and land coming to the market is advertised and property related news is reviewed. It somehow manages to continue to run as a relatively small independent business, even though it has been part of the Reed Elsevier group since 1991. The publisher-author relationship that I experienced highlighted the contrast between academic writing and journalistic commentary. By its very nature, the Estates Gazette relies on capturing sound bites that reflect what is happening in a specific sector at a specific time – with understandably slightly less emphasis on what might happen in the future. By comparison, a specialised textbook on property economics attempts to:

- tease out synergies;
- make connections between concepts and theories;
- create a framework to assess future trends;
- encourage a methodological and analytical approach; and
- help to develop certain skills, perspective and confidence.

It is arguable whether these two approaches are complimentary. In fact, Professor Skidelsky (2010: xi) goes so far as to admit in his preface that: ‘once I had started writing in January 2009 I stopped reading the newspapers on a daily basis to avoid filling my mind with “noise”.’

A distinct advantage, however, of the Estates Gazette relationship was that it effectively framed what surveyors do. In the words of its editor, its business is to inform those who ‘fund, develop, hold, buy, sell, invest, value, manage and give professional and legal advice on offices, shops, industrial property, tenanted homes and new build apartments’ (see Bill, 2013: 83). Interestingly, this definition includes every type of property market except for second-hand residential property – which is an interesting omission, as residential valuation is a part of a surveyor’s work. Evidently, those involved in these types of activity have a crucial need to understand what is going on in an economy – not only because economic activity takes place in offices, shops, factories, and warehouses, but largely because businessmen tend to respect and trust a surveyor’s judgment when taking up new risks. In short, surveyors need to be able to interpret the nature of the current economic backdrop and to be able to give advice on future prospects.

In fairness, a weekly magazine cannot be expected to perform such a rigorous task; this is not stated to demean the role of the Estates Gazette, but merely to recognise its place in some kind of educational hierarchy. First and foremost, professional magazines provide a tool of communication, and at best they provide a documentary record of what has happened over the years. For example, the extracts in the next section are used to pick up the storyline and portray what appeared to be happening in the run-up to the Great Recession.
Evidence of a sector slowly sliding into an abyss

The Estates Gazette, like most journalistic teams, missed forecasting the Great Recession; in fact, their reportage highlighted how the sector appeared to be coasting along, regardless of the occasional alarm bell being set off. For example, in May 2005, the Bank of England flagged up the worrying amount of commercial property debt that was building up in the system. According to their records, outstanding loans awarded to fund commercial development had jumped from £76 billion in 2002 to £122 billion in 2005, representing a 60% increase in three years. Potentially more worrying was the fact that this amounted to at least 10% of total bank lending – coincidentally, the precise percentage that had been reached before the cyclical busts of 1973 and 1991. The Bank of England presented this as a warning, but it fell on deaf ears.

Some commentary on the increase in the size of loan books was flagged up by the Estates Gazette in June 2005, as follows: ‘There is a collective madness at work here: a madness driven by a desire for market share, a madness rooted in bankers’ bonus systems that reward the volume of money lent rather than the performance of the loan. Will this madness evaporate? Eventually, yes. But the sheer weight of money bearing down on the sector, and the prospect of lower interest rates, mean sanity may return later rather than sooner....’

Ten months later, a similar message was signalled by Hank Paulson, the boss of commercial bank Goldman Sachs, who warned the industry to be cautious over loans made to the property sector. The Estate Gazette captured the mood with the following editorial comment: ‘Is the world going crackers ...? Yields have fallen so low it is more profitable to stick the money into an e‐saver account, which currently yields 5.05%. Will capital values continue to rise? Nobody, frankly, has a clue. But it does not require much detective work to discover the prime driver: the lending banks. Only when they curb their enthusiasm for property will the acceleration of values slow. Right now, there is not a sign of that happening’ (Estates Gazette, 22/4/06)

As we now know, the madness intensified and the boom continued for another year. By 2007, the entire market was engulfed in loans secured by various financial instruments – that formed part of the shadow banking network, which is described in Chapter 5. Bankers appeared to be desperate to lend, and investors in property resources behaved as if the party could go on forever.

But then a period of panic struck the international financial markets, and the Great Recession commenced. Problems became apparent, in Britain, in September 2007, when Northern Rock (Britain’s fifth-biggest mortgage lender before it was sold off and rebranded as Virgin money) was granted emergency funding by the Bank of England after finding itself unable to secure loans from elsewhere. This was the first run on a British bank for more than a century, and it set alarm bells ringing in financial markets. Within a year, the whole deck of cards across the financial system of Europe and America had begun to collapse. Uncertainty spread, loan defaults increased, liquidity evaporated, and central banks were called upon to throw financial lifelines to keep many institutions afloat. The overriding problem was that banks had insufficient capital to meet their obligations, and a significant number of banks and mortgage lenders were forced into protective mergers, nationalisation, and even bankruptcy.
Regardless, the Estate Gazette continued to maintain its relatively upbeat and optimistic tone, as the following editorial published in November 2008 suggests: ‘… the consensus forecast from a group of valuers is that the peak-to-trough drop in values will be between 45 and 50 per cent. This alarming number relies on the already known fall of almost 25% between the summer of 2007 and September 2008 …. In one very bleak sense this is good news … Best to write down the value of the loan, extend the terms and hang on in there and hope … Every single bank is ‘kitchen sinking’ down the price of real estate loans. The welcome 1.5% drop in interest rates on Thursday may break the fall … The odd brave buyer can be spotted bargain hunting.’

Obviously a key question is, how does one gain the confidence to know when to call the top or bottom of a market? Hopefully, this textbook will provide some answers, enabling future surveyors to be able to broadly judge the current economic scene and to give reliable advice on future economic prospects.

The unique characteristics of property markets

Slowly, it should be dawning on you why transactions in property related resources warrant a separate economic approach. This is largely because each property is characterised by unique qualities, and these need to be acknowledged before we go much further into our study of property economics. They relate to properties being difficult and protracted to transact, as they differ so much from one to the next (i.e. they are not ‘homogenous’). This can make them difficult to express in value terms. Moreover, they are never traded in prices or ways that can be handled by a retailer, and each unit will quite commonly exceed six-figure numbers. Property also has the problem that it tends to depreciate over long time periods, and when the going gets tough, it can prove to be irritatingly illiquid. If these introductory remarks do not immediately make sense, it may help to preview the opening sections to Chapter 3 on property markets, where students can gain a better understanding of markets and the unique characteristics of property before venturing any further.

The scarcest resource

As presented above, mainstream economists introduce the subject as being about the allocation of scarce resources. Of these, the most important relationships presented as analysed appear to be between labour and capital. There is a distinctly worrying aspect about this traditional approach – namely, the interpretation of capital. The term is used in established introductions of economics to refer to machines, tools and instruments, which businesses need to produce goods and services. It does not include money, shares, mortgage backed securities, or loans that enable businesses to buy fixed and working capital. Strictly speaking, therefore, financial capital is not a factor of production!

As we shall see in subsequent chapters, this oversight is a marked limitation to understanding the essence of the key attributes of a modern market based system. As Liza Minelli and Joel Gray neatly remind us in the film of the musical Cabaret,
‘money makes the world go around’. Without financial resources, businesses cannot do anything. It is the essential oil that enables transactions to take place. Indeed, it was a shortage of available funds that prolonged the Great Recession across so many sectors for so many years. Without financial support, entrepreneurs cannot produce anything. This is as evident in communities that want to buy, sell, rent, or develop real estate, as in any other economic community. Without access to a supply of funds, economies dry up and nothing can happen.

History of economic thought

An aim of this chapter is to explain what modern real estate economics is about so, apart from identifying some basic concepts, the methods employed by economists also need to be reviewed. The methodology of an academic discipline says a lot about the nature of that subject. In general terms, economics is a social science and it attempts to adopt the same kind of value-free approach as other sciences. However, it cannot arrive at universal truths analogous to those in physics and chemistry. Unlike things that are studied by natural scientists, economists are concerned with a study of human behaviour, and that is inevitably complicated by the fact that people have free will, imagination, emotions and a tendency to follow trends. Therefore, when economists use the terms ‘models’, ‘theories’ or ‘laws’, they do so in a broad, generic, sense to promote intuitive, insightful, and instinctive ways of thinking.

It is important to remember, therefore, that there is no one all-embracing economic theory, or method, that can explain everything better than others. Indeed, new economics does not aim to dismantle neoclassical thinking, but simply to put it into context and acknowledge the relevance and value of other schools of economic thought. To make the best of what the subject has to offer, the student should not be brainwashed by one approach but offered the opportunity to experience a plethora of ways forward. This text aims to lay down guides and principles as a means of understanding complex economic systems in the 21st Century, and this entails adapting a pluralist approach that draws on 250 years of economic thought and its associated methodological tools.

The reason that we appear to be stating the obvious is because many economists had become locked in a time warp. Up until 2008, academic and government economists, governors of Central Banks and businessmen, including real estate surveyors, were all under the influence of one dominant academic paradigm – neoclassical economics. It was as if they had a monopoly over the way that economics was taught. This was a great handicap, as they had overestimated the ability of the free market to self-correct. Neoclassical theorists worked from the premise that resource allocation – ownership, production, consumption, transactions and all that economics entails – was determined by individuals. In other words, the preferred ‘modus operandi’ of mainstream economists was to treat people in isolation from one another, working from an assumption that competitive economic behaviour is selfish and rational. Following this logic to its natural conclusion, economic analysis boils down to a simple rule: there is only one representative agent making economic decisions – the ‘rational economic being’ – and such beings act in their best interests and know what they are doing, so leave them alone to get on with it.
The caricature of this generalised pleasure-seeking rational individual lends itself to another important characteristic of neoclassical thinking, and that is a belief in **modelling**. These scientific economic frameworks are often fed with data to reach conclusions and forecasts. It was assumed by lecturers that students can begin to understand how an economic system works (be it competition, the macro economy, normal profits, price equilibrium, or whatever) when they have a reference point—a model—that represents the system in question. Economic models can take on various forms, such as verbal statements, numerical tables, and graphs and even mathematical equations, although there is some question if these really have any predictive validity. As Lanchester (2014: 49) cynically remarked: 'In economics, models are spoken of as being made of physics when in truth they are “Lego”.' In other words, economic models have a provisional and tentative quality and, significantly from an academic position, can be revised, reformulated, and rebuilt.

It seems surprising that this view of the world had prevailed for so long, as not only was it somewhat mechanistic, but it also led to a general blindness to the type of catastrophic failure that could occur in market economies. In fact, some critics went as far as suggesting that neoclassical thinking had become out of sync with the complex global systems that had evolved in the 21st Century. As Ronald Coase (1991) had observed in his Nobel Prize lecture, neoclassical theories were better suited to the analysis of ‘individuals exchanging nuts and berries on the edge of the forest’. This might seem a little disparaging but, for many years, markets were regarded as inherently stable, enabling exchanges of manufactured products, real estate, stocks, and other financial assets at just the right price. There was nothing in the neoclassical model to suggest the possibility of the kind of global collapse that happened in 2008.

Neoclassical approaches had not been rigorously questioned since the last great recession—the depression of the 1930s—when John Maynard Keynes sought to explain how there could be huge amounts of spare capacity in an economy, such as unemployed workers and idle factories, when markets are supposed to equate supply and demand.

Keynes’s model of the economy emphasised that one person’s spending is another’s income, and that the level of demand across a whole economy would not necessarily be sufficient to support full employment of resources in an economy. Indeed, he made a case for government intervention—to use its spending to pump up the level of demand by increasing the amount of income available to the public.

To paraphrase his argument: what might appear to be perfectly rational for the isolated individual can be economically destructive for an economy. To clarify this, Keynes introduced the idea of the ‘fallacy of composition’, which was a complicated way of highlighting that what applies in one case does not necessarily apply when repeated by everybody. In other words, behaviour which may seem perfectly rational for the individual in isolation can be economically destructive if pursued by society as a whole.

A good example of such a fallacy is saving. If an individual saves more, they will increase their consumption opportunities in the future. However, if everyone saves more, there will be less current spending, and firms will produce less; the outcome will be a rundown in national income, output, and employment. If, in these
circumstances, the government, too, tries to ‘save’ more, by cutting down its own spending, this will make things even worse. Eventually, the economy will come to rest in a state of stable equilibrium that is well below its potential of production. This seeming irony of higher saving leading to lower national income was referred to by Keynes as ‘the paradox of thrift’.

The policy implications of Keynesian theory distinguished that the general principles on which an economy must be run are totally different from those that apply to a household or a business. This was an enormous step change, as his advice to governments experiencing a recession was to increase—not reduce—their spending, even if this adds to its deficit. The important objective is to offset the decline of private spending and kickstart a failing economy. Interestingly the IMF, in its *World Economic Outlook* (2014), advocated substantially increased public infrastructure investment. The Italian government subsequently heeded this advice with several expansionary budget measures. Understandably, this alarmed the neoclassical economists but delighted the Keynesians. At the time of the budget announcement, Italy had debts of 138% of GDP, but it was hoped that by expanding the economy with tax cuts and increased spending, the debt would actually reduce.

So Keynes was one of the first to effectively redefine the approach and model adopted by economists. He single-handedly moved the focus onto managing the whole economy—making the case that an economy is different from the sum total of its parts. Thus, what makes sense at the household level does not necessarily make sense at the national level. In terms of economic discourse, the macroeconomic system was identified as a separate entity. As a result, the performance of each economy is now measured by GDP, and managed and manipulated by central bankers and central government (as outlined in Chapters 5 and 7, respectively). In short, the Keynesian approach broadened the economic debate.

**The new behaviourism**

The financial crisis, however, gave added impetus to those who questioned the neoclassical approach. Newer thinking began to gain credence. In particular, many began to explore alternatives to economic models based on the idea of manageable and predictable behaviour. The idea that people gather all the information they need, carefully weigh up all the costs and benefits and then decide what is best is challenged by this new approach. In the new jargon of the behaviourist school, people are not always ‘deliberative’; they often reach decisions in a split-second, by simply drawing on what comes effortlessly to mind—as the behaviourist puts it, ‘automatically’.

In other words, people evaluate day-to-day economic decisions quickly and intuitively, and the process cannot be switched on and off. To paraphrase the ideas of a leading behaviourist: operation of the automatic system involves no sense of intentional control, but it is the ‘secret author’ of many of the choices and judgments that people make (Kahneman, 2011). Behaviourists are not trying to suggest that people are incapable of careful analysis; they simply recognise that, in many instances, people seem to act spontaneously on gut reaction, using just a small part of the relevant information to make a decision.
This new approach emphasises that people are subject to peer pressure, herding, fear and greed. Hence, decisions about choices and how people respond to policy depend on how the options are framed, and their context. In a nutshell, people do not always respond to policy and other economic phenomena in rational ways. People can, and do, make incorrect judgements as they base their decisions on gut instincts, since they are – in a phrase – ‘irrational, illogical, and selfless’.

As marketing strategy informs us, people are increasingly interconnected affected by fashion, peer pressure, social, business and media networks, and these influences are as important as individual motives. Therefore, economists should give up trying to optimise all decisions and be satisfied with general rules of thumb that indicate trends and insight. As a consequence individuals can easily be misled and can make inappropriate decisions. They could, for example, buy property when it is at its peak; and sell, for one reason or another, when it is at its lowest point. In short, investors, consumers, producers do not always act according to the text image of rational economic man. The new approach attempts to understand society, warts and all, from the point of individuals interacting with others in society.

In 2010, the UK Government set up the Behaviour Insights Team (or the Nudge unit, as it is more commonly referred to) to investigate how behavioural economics could be used to improve policy. It has had a profound effect on the way in which Whitehall interacts with the people it is governing. By subtly changing the processes, forms and language used by Government, it has achieved outcomes that are in the ‘public good’ and save money. In fact, in 2014, the OECD published an international review of the initial applications of behavioural economics, stating more than 60 examples of new regulatory policy from a number of OECD countries – in particular, the USA, Denmark, Australia and the UK (see Lunn, 2014 [1]).

Finally, for another excellent summary of behavioural economics and examples of their work, see the World Development Report (2015) [2]. This annual publication from the World Bank took the inspired decision in 2015 to follow how the emergence of behaviourism could affect the policy of development. The timing of these two international institutional publications confirms that the era for a behavioural approach has begun. We exemplify and consider their contribution further at various points in the text but, in particular, in the food for thought section of Chapter 3.

So where do we go from here?

This quick tour of methodology has highlighted the alternatives that economists are currently faced with. Commencing with the (neo)-classic trust in the market, based on rational, competing individuals seeking to maximise pleasure and profits, through the Keynesian model that makes a case for government intervention to achieve the goals of society as whole, to the behavioural school that adopts a distinctive psychological approach to economic decision-making; challenging the processes, forms and language conventionally used to achieve macro objectives and alter market behaviour.

As a result, students today have the benefit of being able to draw from a range of methods, some of which have been in development for more than 200 years,
plus a particularly rich range of official data that governments have been collecting in one way or another for the greater part of a century. The modern economists’ toolbox, therefore, includes models, simulations, experiments, econometrics, and the use of statistical data to confirm theories and test analysis, policy and forecasts. Indeed, it is important to note that new thinking does not dismiss mathematical or quantitative approaches per se. Numerical-based analysis still has an important place in economics; the only thing is that it should not be regarded as ‘the be-all and end-all’. In short, a recurring feature of each school of thought is that they endorse statistical evidence. In many cases, the evidence provides the starting point to build a hunch and gain reassurance to act on instincts. For example, any client willing to accept a surveyor’s ‘gut’ feeling will feel more confident if it is also backed by data. The two are complimentary.

Food for thought: The problems of inequality

The purpose of these closing sections is to reiterate the important points discussed in the chapter, and to raise related issues and questions. For example, in reviewing Chapter 1, it should be clear that the basic principles of neoclassical economics are very much concerned with production, and this raises some immediate challenges about the associated distribution of income and wealth.

In the neoclassical tradition, inequality formed an inherent part of the free market, as it was assumed that the incentive to better oneself would always drive an economy forwards. However, the enormous economic growth achieved in free markets has left many people out of the equation. The irony is that through the process of economic growth, the offer of the opportunity to get richer has been handsomely achieved by a fortunate few, and has left a worryingly large number without the resources to take advantage of the goods and services produced. This is particularly pronounced between the highest income and lowest income countries, where the average GDP per capita differs by a factor greater than twenty (adjusted for inflation and the lower cost of living in the countries concerned – the basis of such adjustments is explained in Chapter 8).

The bottom line is that there are more than one billion people – 14% of the world’s population – still trying to exist on less than $1.25 per day. But income inequality is also marked within the so called high income nations; for example, in the 34 OECD countries [3], income inequality has reached unprecedented levels. In these high-income countries, the average income of the richest 10% of the population is now about ten times that of the poorest 10%, as opposed to seven times 25 years ago (World Bank Group, 2015). The significance of this problem has begun to challenge the conventional economic order, and to raise some gritty new questions – such as, should reducing inequality become a macroeconomic goal?

The World Bank added a further subtle twist to the debate when it recently focused its attention to the poorest 40% in low and lower-middle income countries, the premise being that a society as a whole is more likely to improve if it can increase the income of the least well off. In other words, while it might be arguable that inequality is undesirable, poverty is a greater evil, as the well-being of households in the bottom 40% remains so much lower than households in the
top 60%. Hence, when the central concern of a society is welfare, income growth for the bottom 40% is a far better goal than plainly seeking to reduce inequality per se (World Bank, 2013; World Bank Group, 2015).

**Are all men naturally created unequal?**

The core principles outlined in this chapter convey a general impression that the neoclassical curriculum is all about laws of production; that the *raison d’être* for economics is that a society must produce goods and services efficiently or it will cease to function. In the work of the classic economists, Adam Smith and David Ricardo, these laws were immutable; they were like laws of nature – fixed and predetermined. Distribution seemed to be inherently entwined with other economic ideas. As a consequence, throughout the 19th and 20th Centuries, economists seemed to accept that the way things are made and sold determines how society operates, and who gets the rewards was not such a critical question. Karl Marx’s (1847: 49) captured this line of thought when he suggested that the economic base determines the social superstructure. As he explained more than 150 years ago:

‘Social relations are closely bound up with productive forces. In acquiring new productive forces men change their mode of production; and in changing their mode of production, in changing the way of earning their living, they change all their social relations. The hand‐mill gives you society with the feudal lord; the steam‐mill society with the industrial capitalist’.

So this begs the question: what does today’s digital age of the internet, the smart phone and social media give us?

As suggested in the section on human resources, the internet and related technology has seriously changed the nature of work. In some sectors, it is as if labour has been divided into two polar extremes: a small band of highly skilled – and highly paid – innovators that manage and adapt new technology, and a large number whose jobs have been replaced by machines and robots, or reduced to tasks that are far less demanding. This has seriously affected the reward structures, as has the explosion in executive and director remuneration, which is discussed in more detail in Chapter 4.

For example, one of the many statistics bandied about is the fact that the richest 1% in the world absorbed more than 60% of the increases made in real incomes between 1988 and 2008 (Milanovic, 2013). The only section that did better was the top tenth of that 1%; and the top 100th of that 1% did best of all. Specifically in the UK, there was some debate in 2015 about whether those on the lower and middle incomes had actually benefitted at all from the recovery from the great recession. In short, new economic thinking has always been concerned about distribution; as the data universally demonstrates that the benefits of economic growth are going to increasingly smaller numbers of people each year. The scale of the inequality was succinctly captured by an Oxfam advert in November 2014 which pointed out that the richest 85 billionaires had the same wealth between them as 3.5 billion poor people – i.e. half the entire global population.
Inequality on such a tremendous scale is the outcome of wealth tending to concentrate into the hands of fewer and fewer families. The rich get richer and the poor get poorer. As Piketty (2014) observed in his widely read treatise *Capital in the Twenty-First Century*, wealth accumulation is ‘one of the great divisive forces at work today’, and this is particularly worrying as the percentage return to capital (wealth) is higher each year than the percentage of economic growth. In short, the problem of inequality is getting steadily worse. This is a serious problem, as there is potential conflict between the ‘haves’ and the ‘have nots’. The billionaires, whose income is from property and assets, and ordinary people involved in the production of goods and services, experience life and the opportunities it offers in totally different ways.

**Does an unequal distribution of income and wealth matter?**

It is not only the empirical evidence on inequality that should concern us, as there is evidence to suggest that the rise in income disparities will eventually limit economic progress across society as a whole. In the context of the storyline explored in this text, the problem of escalating inequality has also been used as an explanation to account for the run-up to the financial crisis of 2008 and the subsequent recession. This theory was first put forward in 2005 by Professor Raghuuram Rajan, when he was still chief economist at the IMF (he is now governor of the Bank of India). As he saw it (and the implication is that he was one of the few economists who actually ‘saw’ the crisis coming), deregulation and securitisation encouraged bankers to take on more complex risks. At the root of these risks were the subprime borrowers – the poorer members of society seeking loans to purchase housing – whose stagnant incomes would not conventionally support sizable debts.

When this group of borrowers defaulted on their mortgage payments, banks were put into serious difficulties – and it was not just those directly granting mortgages, but anyone holding securities which included the subprime debt. In fact, the collapse of subprime mortgages in the USA quickly raised questions about the ability of banks to meet their worldwide commitments, and a good number of banks around the world had to be bailed out by governments. We examine this part of the story further in Part B of the text.