

Price mechanisms rationing function in the property market



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Land economics is a branch of economics which focuses on the uses and the role of land in the country's economic. It is said that land is crucial in shaping how well a city functions and who gets the benefits from urban growth. In the past, land economics is said to focus on ecological sustainability but in recent decades, a new branch of economics which is environmental economics is made to replace it. Even so, land use still has a high impact on health and environment and thus one of its fields of focus is still on the environmental ramifications.

Land economics is often related to resources as the resource of land is scarce and limited. With this in mind, land speculation occurs everywhere all around the world and this caused situations in which supply cannot meet the demand. This is because the supply curve of land is stagnant and will not be affected by the change in demand. The resources available on the land such as minerals, forest products, land resources and water are also regarded important in economics as they are the raw materials needed. Thus land is important in land economics as it provides raw materials for the working of the market and that is why it is categorized as one of the factors of economics on par with labour and capital.

Other than this, land economics also focusses on the land use. Different land has different type of land use and this will affect the country's economic growth in a certain way. For example, if a land in the hills are made for industrial purposes, the cost of production would have increase as the cost to transfer the goods from the manufacturers to the retailers would have increase a few fold and this affects the efficiency which in turns affect the economic. Thus it is crucial to have a well detailed plan on the land use of <https://assignbuster.com/price-mechanisms-rationing-function-in-the-property-market/>

each land. This is because the land use directly influences the activities and productivities on the land. Thus we can also say that land economics is focused on land allocation as land is a scarce resource and its value is well influenced by its availability. This means that the allocation of land resources plays a critical role on how each land is treated. For example, in packed cities, land can be scarce and difficult to obtain, and it has a correspondingly high price. In rural regions, however, land may be very inexpensive due to decreased demand. Thus land economics is focussed on the allocation of resources to manage the supply and demand of each area.

Neo-classical economist gives very little interest to land as they typically treat land as a factor of production equivalent to the factors of economics capital and labour. Keynesian economist also gives very little concern to land because typically their analyses focus more on consumption, saving, investment and other economic aggregates. However, a georgist (geographical analyst) named Henry George has different ideas on the field of focus of land economics and have divided them into a few parts which are urban development, wealth inequality, housing affordability, environmental concerns and economic cycles. Henry George's analysis stemmed from both ethical and economic considerations. He was primarily concerned with exploring the reasons why poverty and destitution coexisted with economic growth, and saw the root cause of these problems in the prevailing policies towards land and have deduced that it is because of the fields of focus of land that caused these economical and ethical problems.

Urban Development

One of the most concerned fields of land economics is the urban development. Land economics focusses on urbanisation as it is one of the factors that drive growth in a country. With the ownership of land, people would start to develop structures on the land which in turn produces activities and causes productivity on the land. This is because there are quit rents to be paid for the ownership of a land and without activities that generates profit on the land, the land is a liability and not an asset. This in turns causes urbanisation if planned well. Urbanisation also gives many economic advantages such as production, consumption (demand) and distribution (supply). This is what drives the monetary value to circle around the market.

Wealth inequality

George strongly emphasis that land is the symbol of wealth as land is scarce. Thus the ownership of a parcel of land symbolizes the wealth of a person as private ownership of land strips of the community from the benefits of that land. Thus George says that land economics focuses on the wealth of the community and has implements many policies to curb price speculation in order to cater for the poorer groups who only afford to pay rent for the land.

Environment Concerns

As mentioned previously, environment concerns are one of land economics concerns. This is because the usage of land and its resources will deplete the environment of these raw materials. George said that in order to preserve the environment, price mechanism in the form of taxes should be carried out. The usage of an environment's resources should be taxed accordingly to <https://assignbuster.com/price-mechanisms-rationing-function-in-the-property-market/>

prevent misuse. But he still doubts that price mechanism will be efficient enough to curb environment threats. For example, the creation and maintenance of national parks requires direct regulation of land use such as which area can logging be carried out. He said that the market, even when modified by taxes, cannot absolutely guarantee the conservation of such crucial assets. In other words, protection of 'natural capital' or 'land' may commonly require regulation as well as taxation. Thus environmental factor is a field of focus of land economics in order to have a long and sustainable usage of its resources.

Housing Affordability

Land economics is also concerned about the house affordability. This means that the house price is compared with the average income each household could generate. This determines whether or not the household affords to buy the particular house. Land economics is also concerned of the inflation throughout the years in the real estate sector as this is a large barrier for home ownership for the younger generations as they would have to pay their loans for longer years. Thus one of land economics focus is to decrease the inflation rate. The main determining factor in housing affordability is the supply and demand of land. When there is increasing demand with no increase in land supply, the house pricing would increase proportionally. The demand for land involves both use values and exchange values. Use values are values such as security and shelter while exchange values are the house pricing or capital appreciation. With an increase in demand, there will be an increase in price as the supply is limited. Thus, housing affordability is one of land economics' field of focus.

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Economic Cycles

George has carried out a research and has said that the boom and bust of the property market mostly coincides with the fluctuation of the overall country economic performance. This is because the quit rent received from land can be used to invest or offset government developments for the society. This policy implies that, by smoothing out cycles in the housing market, a uniform land tax could help to avoid periodic crises in economies more generally and this will produce a more stable national economic. That is why he says that economic cycles should be one of the fields of focus of land economics.

Question 2

What is the Importance of Price Mechanism in the Property Market?

Price mechanism is the system of interdependence between supply of a good or service with its price. Adam Smith described price mechanism as an invisible hand which regulates the economy. Generally, price mechanism sends the price up when there is a shortage and sends the price down when there is a surplus. Price mechanism is also able to increase or decrease supply indirectly using price as its control factor. In a nutshell, price mechanism is the regulating of the supply and demand of the market using monetary values. It plays few important functions which are rationing function, signalling function, allocating function and incentive function. In the property market, price mechanism also plays its roles and functions as in any other market.

Price Mechanism's signalling function and allocating function in the property market

Figure : Demand curve shifts upwards
Signalling function in price mechanism means that prices are able to convey sufficient information to the consumers and suppliers in the market for their economic activities. The increase in price of a product sends signals to the suppliers to increase the production and vice versa. This can also be shown in the supply and demand curve.

When the price of a good increases from P_1 to P_2 , this signals the suppliers that the demand of the goods has increased and the demand curve shifts upwards. This causes the suppliers to increase their production from Q_1 to Q_2 as they are able to generate more profit and to meet the demand. These phenomena can also be seen in the property sector. For example, when the price of Service Apartments rises, the developers know that the demand for service apartments have rises and thus they start developing more and more service apartments. This also happens vice versa, when the value of a property falls in a certain area, the developers know that the demand for that area is low and thus they would not chose that area to develop the type of property. Price mechanism also has other roles such as helping entrepreneurs cut costs. For example, when the cost of building a terrace house has increased which decreased the marginal revenue of a developer. This acts as a signal to the developer where they will try to find cheaper or alternative resources in order to cut the cost of production to attain maximum revenue. As a result, price mechanism is helping the developers in allocation of resources.

This also works in the long run such as with landed properties. When the value of land continues to increase, this signals the developers that the future generation will not be able to purchase such properties. This means that the demand for landed properties will eventually fall in the future even if it does not decrease fast, it will still decrease eventually as only a few would have the purchasing power and is willing to buy such properties. Eventually, companies will start to develop alternatives such as high rise properties and their resources such as land, capital and labour will be allocated accordingly to start developing high rise properties. Thus price mechanism functions as a signalling and allocation function for the developers where the developers make decision based on the relative market price of the property. This helps manufacturers achieve economical and technical efficiency where there is a minimum wastage of resources as they are used to their most valuable use.

Price Mechanism's Rationing Function in the Property market

When resources are scarce, demand exceeds the supplies and thus the price will be driven up as there is a shift in the demand curve or shortage. The increase in price is to discourage the continuous use of the resource without planning and conserve them. The market price of the product would act as a rationing device to equate the demand with supply.

This can again be explained using the demand and supply curve. For example, the scarcity of petrol stations in a vicinity is showed by the supply curve. This scarcity occurred due to government intervention where petrol stations are limited and controlled due to the scarcity of petrol. Assuming the government has decreased the amount of petrol stations in an area, that

would shift the supply curve from S_1 to S . If the market price continues to stay at P_1 , the demand of petrol station would still be at Q_1 while the amount of supply available is only at Q_2 . This creates shortage in amount of petrol station available. Thus the market price acts as a rationing function where it increases the price of each petrol station from P_1 to P_2 . This would cause lesser entrepreneurs to venture into this field of business as the profit margin has decreased with the increase in cost which in turns lower the demand for petrol station. Thus the market price is regarded as the rationing agent to equate the demand and supply to achieve market equilibrium.

Price Mechanism's Incentive Functions in Property Market

An incentive is something that motivates a producer or consumer to follow a course of action or to change behaviour. Higher prices of a product provides incentive to producers to supply more of the said goods. Discounts or other services provided along with the good also acts as incentives for the consumers. For example, the lower interest rate in mortgage loans for a certain type of development act as an incentive to consumers as now their mortgage value would be lesser and this would increase the demand for the development. This is how a price could act as an incentive to affect the choices of consumers. They can also exist in the form of subsidies. Another example is can be shown by Mah Sing's recent promotions on all of its service apartments. Mah Sing forecasted that in year 2014, the demand for service apartment would fall and thus they are giving out promotions and good incentives in order to clear the units that they are still holding.

Government Intervention in Price mechanism in the Property Market

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Government intervention are usually in the form of taxes or subsidies. If the rate of an indirect tax such as stamp duty increases, the relative price of a product increases and this will cause a decrease in demand of the product. The government is intervening in the market as it wants to change the price signals of producers and consumers. For example, many investors are coming to invest in Malaysia due to the cheap price in property and this increases the price of the property as investors will try to sell it at maximum profit. Government who wants to prevent this would increase the tax rate on foreign investors and this would cause the profit margin to lower and in turn decrease the demand by foreign investors. The increase in property price for foreign investors sends out a signal telling them that it is not worth it to invest in Malaysia now.

Even though government also uses price mechanism to control the market, the price mechanism does not work as well in an imperfect market compared to a perfect market. This is because there are price ceilings and price floor for certain products. For example is the low cost apartments. These apartments can only be sold at a maximum of RM 40, 000 in the past. Thus, RM 40, 000 is the price ceiling for such low cost houses. But what happens when the prices of properties continue to increase? The price of all other properties increases while the price of low cost apartments stay stagnant. This would increase the demand of low cost apartments and causes a shortage as the developers would not be so willing to supply so many low cost apartments as the profit margin is lower compared to producing normal houses. But since the price is unable to be adjusted, there is a big flaw in price mechanism to prevent such problems. Thus other government policies

would need to be implemented to control the situation such as limiting the people who can purchase low cost apartments or making developers build low cost apartments for every 10 acres of development mandatory.

Question 3

The price of housing determines the price of residential lands. Do you agree or disagree? Support your answer.

I agree that the price of housing determines the price of residential land. People often think that the high price of land is responsible for the high house prices but I believe that the house price is what affects the land value. Dr Ernie Jowsey, Principal lecturer in Applied Economics in Sheffield Hallam University, UK says that their analysis gives support to how house price influences the land value in an unconstrained market. According to Dr Ernie Jowsey, an increase in the demand for houses will increase the price of old houses. This is because more people are willing to purchase houses and this will cause competition and the bidding price of each house would increase. With this in mind, developers will be more willing to pay higher in order for them to purchase more land to develop them into housing estates as their profit margin would have increase with the increase in house price. Thus he concluded that the increase in house prices due to demand has increased the value of the land the houses are built upon and not vice versa.

For example, an old house was constructed in the year 2000 at a cost of construction of RM 300, 000. The house was then sold for RM 450, 000 in the same year. In year 2012, the demand for houses in that area has increased compared to other properties such as industrial properties as the area had <https://assignbuster.com/price-mechanisms-rationing-function-in-the-property-market/>

become a commercial hub. Thus the asking price for such a house in that area had increased to RM 800, 000 in the past 12 years. People believe that the increase in price is due to the increase in land value but actually it's because of the increase in demand and housing prices that have caused the increase in land value. This can be proven when the industrial area's land value did not increase as much as the residential areas because the demand for industrial land was not so high compared to residential land. The cost of construction for that same house have not changed in the past 12 years and stayed at RM 300, 000. Thus the remaining amount of RM 500, 000 (RM 800, 000 - RM 300, 000) in the year 2012 is regarded as land value. Thus Dr Ernie Jowsey concluded that the demand for houses in the area has increased the asking price for houses which in turns increased the land value due to the increase of house prices. The Digest of Building Land Prices (Estate Gazette, 1974) also supports Dr Ernie Jowsey's analysis by stating that " land prices are determined by house prices rather than the other way around".

Another explanation in which land value is not affected by the house price was given by Dr Ernie Jowsey in order to support his previous hypothesis. He stated that ' Since the price of land is determined by the demand for housing, controlling its price artificially would not result in house price falling'. In my understanding, Dr Ernie Jowsey is trying to tell us that even if the land value of an area is changed artificially as in by the owner's own will, the housing price of that area would not decrease or increase. For example, a terrace house with land area of 2, 000 square feet is worth RM 300, 000 in the area including the land cost. The market value a vacant residential land with such a size would cost RM 100, 000. Assuming the land owner of a

vacant land wants to increase their asking price above the market value in order to get a better profit and has increased the price of the land to RM 120, 000. Contractors then bought this piece of land to construct a similar terrace house but their selling price would still be at RM 300, 000 as this amount is the amount at which people are willing to pay for this type of terrace house in the area regardless how much the contractor had paid for the land. Thus Dr Ernie Jowsey concluded that the increase in house price would increase the land value while the change in value will not bring any effect to the housing price.

Based on my understanding, land value is influenced by house prices. This is because in our regular valuation calculation such as comparison method, house prices have been indirectly factored into the calculations. During the valuation of a land, the most looked into factor of the subject property is its comparables and their location. But what makes the value of the location higher and lower? It would be the price of the buildings or houses in its surrounding area. For example, a land with high end residential units would have higher land value than a land located with low cost residential units. This is because its comparison data would all be high end units. The location would also have a better adjustment as the view, amenities and facilities in a high end residential area is better than a low cost area. Thus the price of the housing on the land itself is influencing the land value. Thus it can also be said that if the same piece of land is used to develop low cost units, the land value would have been different.