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## The Evolution of the Market Value Definition

**Abstract:** The purpose of the study is the following: (1) indicate the economic sources of the definition of value, including the market value of real estate, (2) present the definition and interpretation of this category, (3) its evolution and the difficult path towards its acceptance in Polish conditions, and (4) identify the reasons for this category being frequently misunderstood in the professional environment. A research hypothesis was put forward that the market value is of a contract nature, its definition and interpretation may change. The study employed a critical analysis of the source literature and legal documents as its methods.

**Keywords:** market value, real estate, market, valuation, price

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## 1. Introduction

Value constitutes an indispensable category in management processes. It has been accurately defined by Kołodko who stated that “the economy without value is like life without meaning” [1, p. 164 – transl. from Polish]. Despite the fact that this category is so common, it is considered one of the most difficult in economics and remains the subject of debates. In the course of discussions addressing the concept of value, the answers to basic questions are frequently sought, such as, e.g.: is value tangible, i.e. assigned to a particular item, or intangible, is value subjective or objective, what are the sources of value creation, what factors influence value, should value focus on economic elements alone, or should it take into account the external effects, and what is the transition mechanism from price to value. Not all of these questions have been answered unequivocally. As a result of the centuries-old discussions, it has been recognized that the economic concept of value is not inextricably linked with a good or a service. Value is not a material category, it is not attached to a particular good, but rather represents an intangible value created outside this good in the minds of market participants [2, p. 19]. At the stage of valuation, it will always include subjective elements, even though the market needs its objectification. This objectification is never absolutely full. In the field of economics as a social science, objectification is extremely difficult to accomplish, a researcher is always influenced by his/her world perspective and interprets particular phenomena through the prism of his/her own hierarchy of values. A statement about value is a normative judgment based on subjective assessments.

The considerations addressing the category of value were of a philosophical nature [3]. Over the centuries, the views regarding the sources of value creation have continued to evolve, having initially been identified with the sources of wealth. Historically, the standpoint presented by the Austrian school prevailed and this approached value as a function of demand with its basis being the utility of a given good. The contemporary theory of value, referred to as subjectivist, is based on individual assessments of value made by the market participants. Value ceases to be a subjective notion when it begins to reflect collective perceptions of market participants. Market value is formed by constantly fluctuating subjective values. Therefore, the level of market value is also subject to continuous alterations.

The complexity of the world, the growing awareness of the role played by the low-quality environment and the requirement to respect limited natural resources inevitably lead to the need for changing the systems of value. Their evaluation is demonstrated through the promotion of corporate social responsibility, sustainable development and the implementation of responsible investment strategies. The 2007–2009 crisis revealed that value should not be perceived through its economic dimension alone, it should also cover environmental, social as well as ethical and moral dimensions. Such a viewpoint allows us to not only approach value through the prism of current benefits. It has to be a perspective extending beyond the life of

one generation. The market mechanism cannot constitute the basis for economic valorisation. The economy has to offer various mechanisms of valorisation [4, p. 119]. An unambiguous definition of value is difficult to arrive at and the question remains as to whether it is possible at all.

The theory of value provided an incentive for the development of the theory of valuation. A. Marshall [5] is considered the first economist to be credited with separating the theory of value from the theory of valuation. The theory of value aims at explaining why assets have a given value, whereas the theory of valuation explains the validity of using processes and techniques to measure value.

The difficulties in defining the essence of value discouraged from addressing this category. The discussion on value, so frequently undertaken in the 18<sup>th</sup> and 19<sup>th</sup> centuries, lost its popularity in the 20<sup>th</sup> century as economists increasingly focused on prices. It is confirmed by the following opinions: in 1903, Cassel stated that the theory of value in economic sciences is redundant and that it should be replaced by the theory of price [6, p. 14]. Also in 1974, Wend argued that there is no need to develop the theory of valuation, it is better to refer to the theory of price [6, pp. 14, 20]. Such attitudes were favoured by the disappearance of classic free competition markets in favour of the markets where it was more difficult to ensure the anonymity of buyers and sellers, characterised by the limited rationality of behaviour presented by entities resulting, on the one hand, from the need to act in the conditions of limited access to information and, on the other, caused by opportunism, i.e. the pursuit of one's own interest with no regard to legal order, customs, traditions or arrangements, strong diversification of the objects undergoing exchange [7, pp. 42–43]. It may be assumed that the discussion on value was abandoned due to the strong development of securities markets, markets with a relatively high level of efficiency, where prices quickly reflect changes occurring in the environment, and thus where prices can be considered a good measure of value.

## 2. Objectives of the Study, Research Hypotheses

The real estate market is not an efficient market. It is considered to be a market characterised by a low efficiency level, both in terms of operational efficiency, which refers to the choices allowing decisions to be made at the lowest cost, and allocative efficiency determining the best form of use. It means that prices do not reflect all the changes taking place in the environment or, more simply, that price cannot be equated with value. Despite the definitional difficulties and problems at the stage of valuation, this market is doomed to use the category of value, to search for an appropriate definition, its interpretation and measurement methods.

The purpose of the study is to indicate the economic sources of the definition of value, including the market value of real estate, provide economic interpretation of market value, present the definition and interpretation of this category as

well as its evolution and the difficult path towards its acceptance in Polish conditions, and also identify the reasons for this category being frequently misunderstood in the professional environment. Only the correct definition and interpretation of market value determines its proper measurement and usefulness in economic transactions. A research hypothesis was put forward that market value is conventional in nature, and that its definition and interpretation may change. Critical analysis of both the source literature and legal documents were used in the study.

### **3. The Contribution of the Theory of Value Useful in the Valuation Process**

The theory of value suggests important expressions are useful in the process of its exploration and interpretation. It is worth paying attention to a few of them:

- Value begins in the future rather than in the past, because it depends on the need for a particular good, i.e. on the utility of this good. Therefore, one of the most important economic principles of valuation was the principle of anticipation [2]. An investor does not purchase the past or the present, an investor buys the future. In order to meet this requirement, when searching for dominant values, it is assumed that the expectations about the future are reflected in the recently concluded transactions. It means that the period of market analysis, constituting the basis for collecting information needed to search for market value, should not be long.
- The level of value depends on the impact of the supply and demand factors. A. Marshall compared both elements of the market to scissor blades, because no category can be ignored in the process of determining value. However, he emphasized the importance of time in influencing these two market elements: in the short-term perspective supply remains relatively constant, and value is a function of demand [8, p. 50]. This means that the shorter the period of market analysis, the greater the role of demand, the longer the period, the role of supply increases [3, p. 301]. As the value is determined at a given date, i.e. the valuation date, the demand side is more important. The valuation model is an investor model.
- The difficulty in objectivizing economic phenomena causes that determining the value of each good is burdened with uncertainty and constitutes a source of risk. The uncertainty of valuation has been considered a real and universal phenomenon in the process of each good appraisal [9].
- Land is a special capital good; it is a limited one, i.e. a scarce good. The stability of total supply is a specific feature of the land market. The demand for land, similarly to other factors of production, is not a primary demand (neither direct nor final), but a derivative demand, because it results from the demand for products and services in the production of which these factors are

used [10]. At the same time, this good has no substitutes, i.e. fungible goods. This good is characterized by a low-price elasticity of demand (an increase in prices causes less than proportional decrease in demand). On a global or a nationwide scale, the supply of land is inelastic (price increase does not trigger any reaction on the supply side). Sparse resources should be used efficiently. The increase in land prices results in searching for methods to use them as intensely as possible. Hence, the concept of resource efficiency is the basis for determining the value of goods.

#### **4. The Basis for Defining and Interpreting Market Value of Real Estate**

A real estate has to present certain characteristics in order to have value, i.e. not only remain useful but, at the same time, be limited in quantity, attractive to buyers with sufficient purchasing power and marketable. The utility of a given good determines the demand for real estate. The size of demand is influenced by the particular good scarcity, the preferences of buyers and their purchasing power. Likewise, the supply of a good depends on its utility, is limited by the good scarcity and low purchasing power of the population. A real estate has to be marketable for the aforementioned factors to affect its value. This means that even though the factors determining value creation occur separately, they interact and have an impact on both the supply and demand of a given real estate.

Market value is the most common type of investigated value. It is considered to be “[...] an inherently simple concept – an objective value created based on many market behaviours – however, the definition of market value is controversial. There are ongoing discussions addressing this issue, frequently focused on very subtle differences” [8, p. 40 – transl. from Polish]. These discussions resulted in the evolution of the concept of value. The importance of this category in market processes caused defining and classifying it in both international and European valuation standards as well as in the European Union legislation, obtaining a uniform definition and interpretation. It has been defined as: “the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion” [11].

It is worth noting that this definition not only applies to real estate, but also to the entire group of assets. The definition and its interpretation are strongly embedded in the achievements of economic thought, has a strictly economic dimension, its aim is to objectify the market and, moreover, is not of internal, but of external nature. In accordance with the contribution of economic thought, it is created in the minds of market participants, representing the accumulation of their most common behaviours. The real estate valuer has to be aware of the importance of the definition

assumptions: meeting the requirement of the parties being independent from each other, having no obligation to participate in the transaction, presenting a firm intention to conclude it along with prudent behaviour and understanding of the market realities. The last condition in the definition of value is focused on market exposure and negotiation time: the marketing and negotiation period is over for both parties. It means that the value level is determined at the valuation date as if the valuation objective was to be achieved on that date. As this assumption disrupts the logic of the market functioning, some argue that market value is a fiction, a myth [12]. Meeting the assumptions of the market value definition requires refining market data by removing the information from transactions which does not meet these conditions. The graphical interpretation of arriving at the value is presented in Figure 1. The unit prices of similar properties are displayed on the x axis. Although they are similar, the price spread is significant. Real estates are similar but never the same. The discrepancy in unit prices may not only result from differences in the real estate characteristics, but also from various conditions related to concluding the transaction: different knowledge of the market, varied motivations for taking actions, diverse relationships between the market participants, different time spent on market exposure and price negotiation. Time will depend on the real estate market activity, on the market segment from which the appraised real estate originates, on its specific features, such as: cubature, material and technical solutions, multiple functions, physical location. Market exposure and negotiation period are relatively longer in the case of less active markets, in the markets requiring a relatively large capital, or the properties atypical for a given market segment. A valuer does not determine market value, because it is an entity defined by the market, a valuer discovers market value. His/her task is only to present facts about the market, whereas the methods used represent an instrument allowing him/her to discover the market value which objectifies the market [13, pp. 25, 46) by attempting to break the market code. The condition for conducting an effective investigation is the greatest possible similarity of not only the real estate but also the terms and conditions of the transaction. Therefore, a valuer has to distinguish the range of unit transaction prices referring to similar properties, in which the number of concluded transactions is the highest. In the presented figure, it is the price range determined by  $C_{\min} - C_{\max}$ . The other transactions should be disregarded. It can be assumed, with high probability, that the definition conditions of market value were not met in the rejected transactions. It means that a valuer does not have to search for the detailed information about the terms and conditions of each transaction individually. That would be impossible. A valuer is looking for the range of unit prices with the highest number of concluded transactions. If the parties are related, if they have no firm intention to enter into a transaction, if they act under compulsion, if they are not familiar with the realities of the market, or if the transaction was characterised by an insufficient market exposure and negotiation period, the unit prices will deviate from those within the designated ranges. Next, the properties which constitute the basis for determining

the real estate value are selected from this range. As there is the highest number of transactions in this range, this value is free from many subjective aspects and begins to reflect the collective behaviour of market participants.

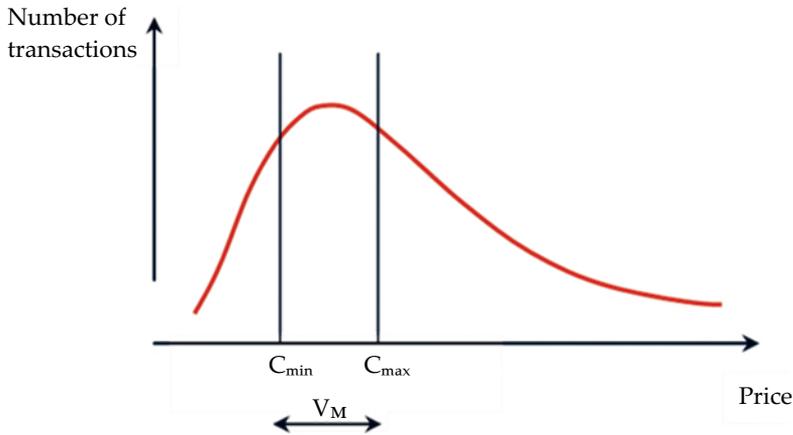


Fig. 1. Graphic interpretation of determining market value ( $V_M$ )

Apart from the definition components, the interpretation elements are also important for understanding the essence of real estate market value. Market value should reflect real estate potential. It results from the provision that it has to be determined adopting the optimal way of its use, referred to in Poland as the most advantageous use. It means the most likely use in the market which is physically possible, adequately justified, legally permissible, financially feasible and results in the highest value of the appraised real estate component. This condition was introduced in 2005 by the International Valuation Standards (IVS) and was considered the **heart** of the valuation process. It shows that a real estate subject to valuation cannot be considered as a legal or technical category alone, it also has to be approached as an economic category. The IVS rightly emphasize that the real estate valuer enters the area of economics [14, p. 38]. The value as well as the market in which it is created represent economic categories. Economics as a social science deals with the principles of management, including the management of rare resources, striving for the most effective use of these resources. Rare resources include land and buildings. The need for introducing this principle is indicated through the interpretation of Figure 2.

In general, the value of land grows and the value of buildings declines caused by technical wear (line  $W - W_T$ ) and faster functional wear (line  $W - W_F$ ). Functional wear may appear as early as in the design phase. An increase in the value of land, frequently surging rapidly, causes – along with the decreasing value of buildings – disturbances in the so-called internal equilibrium recognized as one of the principles of real estate valuation, forcing the decision not only about its renovation,

modernization, but also using this land by adding a superstructure, changing the function or even its demolition and redevelopment. If the valuation was not accompanied by the above-mentioned assumptions, the value of developed land would often be lower than the value of land, thus resulting in the value of development reducing the real estate market value.

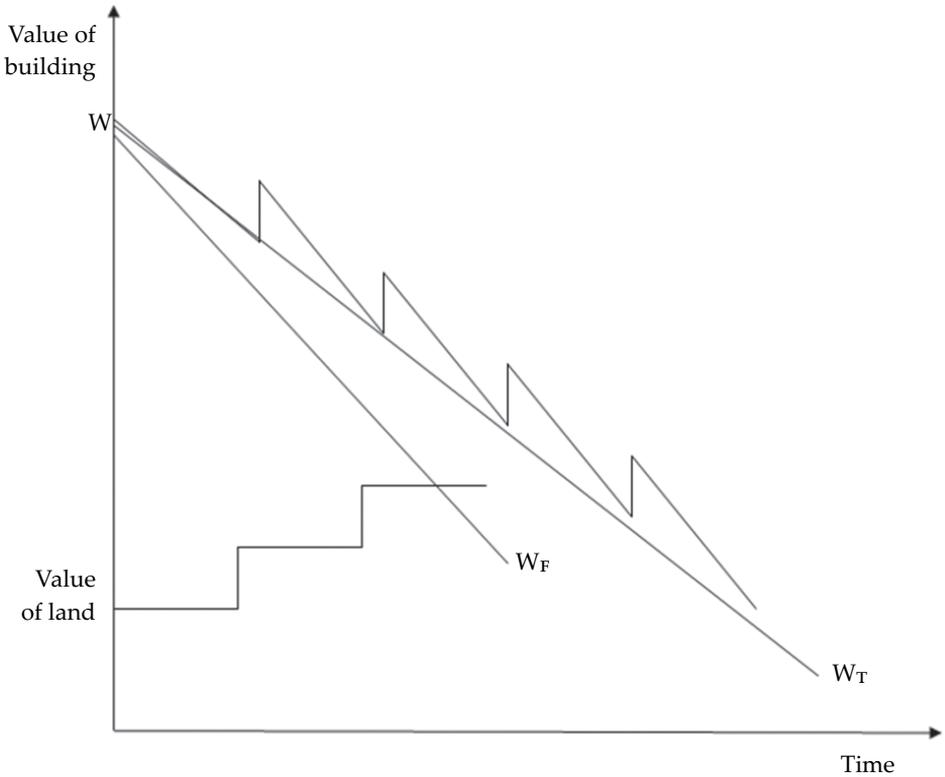


Fig. 2. Changes in the value of land and the value of buildings

The best use has to reflect experience confirmed by the market rather than the best performance of a particular real estate. An optimum use can be defined either for the continuation of using the assets or for an alternative use.

The h&b use principle has also been accepted by TEGoVA. The European Valuation Standards (EVS), by accepting the principle of the “highest and best use” as an integral part of market value, introduced an additional condition, the so-called “value of hope” which is a component of market value. This condition serves to

[...] describe the increase in value which the market is willing to pay for the real estate hoping that the real estate will gain an alternative use option or a possibility of its development will emerge resulting in its value increase over the one achievable with the currently applicable development (and expansion) restrictions, the existing infrastructure limitations or other applicable constraints [15, p. 25].

Contrary to the best use, the “value of hope” does not have to comply with the legal requirements at the date of valuation, thus it fully reflects the real estate potential, if there is one on the market. However, obtaining the approval for a change in use is possible [16, p. 32]. It has to take into account the likely costs to be incurred along with the time needed to implement the project, as well as the risk of its failure.

## 5. The Difficult Path to Accepting the Commonly Applicable Market Value Definition

In the conditions of a non-market economy, the valuation process in Poland was dominated by the category of replacement value, reflecting the phase of creation. The transition to market economy challenged the cost-of-production value theories of the past and the undertaken privatization processes required specifying the market principles of valuation and defining market value. The following several stages of reaching the current market value can be identified:

**The first stage was initiated in 1994** by issuing the first document regulating the valuation methodology. Ahead of the legislative process, the Ministry of Spatial Management and Construction published the *Temporary principles of real estate valuation* [17] recommending their application. Both the valuation methodology and the definition of market value were modelled on British standards. In this document, market value was defined as:

[...] the most likely price to be obtained in the conditions of a normally functioning market, having adopted that:

- the parties to the transaction are independent of each other and neither of them is acting under compulsion,
- the real estate is exposed on the free market for a sufficiently long period of time, considering the nature of rights in the real estate and the market situation,
- the parties to the transaction are aware of the advantages and disadvantages of the real estate,
- there are no other specific conditions restricting free operation of the market [17, p. 8 – transl. from Polish].

However, no explanations were provided for the definition, which certainly caused – considering the complexity of this category – a lack of understanding and freedom of interpretation in practice. The phrase “the most likely price to be obtained in the free market economy” may, without appropriate comment, be understood in a very different way: as the lowest value on the market, because of the highest probability that the property will be sold at that price, as the top market price, as the arithmetic mean of unit prices, or as the price to be paid by the buyer. Neither of these responses can be considered correct as they misinterpret the discussed category. If the market value is to objectify the behaviour of market participants, it has to reflect the leading trends: it is the typical, most frequently obtained price. Such explanations were missing in this document. However, it is important to underline that this document was the basic source of knowledge and regulations in the area of

real estate valuation during the initial development period of the real estate valuer profession, real estate market and real estate management.

**The second stage, implemented in 1995**, was characterised by two important events for the community of real estate valuers. The first referred to the publication of the Ordinance of the Minister of Spatial Management and Construction of March 1, 1995 on the detailed rules for determining the real estate value. In §5(1) the legislator stated very briefly that the market value “[...] is understood as its expected price at which the real estate can be traded” [18 – transl. from Polish]. It was a significant narrowing of the concept of market value in the provisional valuation rules. Such a formulation, yet again, opened up a wide range of interpretation possibilities in the practice of valuation. The second event that can be considered a cornerstone for developing the valuation methodology basics in Poland was related to the publication of the first Professional Valuation Standards by the professional organization [19]. They constituted the basic source of knowledge and regulations in the field of real estate valuation in the initial period of the real estate market development and the establishment of a real estate valuer profession. They took into account the requirements of the European Group of Valuers’ Associations TEGOVOFA (currently TEGoVA). They reached out for the British experience to the greatest extent. One of the standards, standard III, addressed the definition and interpretation of the real estate market value as the basis for valuation. This standard introduced two types of value: market value and replacement value. Market value of the real estate was defined as:

[...] **the most likely price** at which it can be traded, having adopted the following assumptions:

- a) the parties to the contract **are** independent of each other and act rationally, not being guided by any specific motives,
- b) **have** a firm intention to conclude the contract,
- c) **are** aware of the coexisting circumstances affecting the real estate value,
- d) **do not operate** in the situation of constraint,
- e) the required period of the real estate exposure on the market, using appropriate advertising, and the time needed to negotiate terms and conditions of the contract **has passed**, considering the nature of the real estate and the market situation [19, p. III.1/1 – transl. from Polish].

This definition introduced new elements as compared to the definition in the *Temporary principles of valuation* [17]. Firstly, it assumed that the parties were acting in a rational manner, not being guided by any specific motives, and secondly, it introduced the requirement of a firm intention to conclude the transaction. It highlighted the rationality of behaviour, i.e. the need to make decisions based on the current market situation and to eliminate speculative behaviour. Adopting the requirement of a firm intention to conclude the transaction – in addition to the assumption that the parties are not acting under any compulsion – eliminates market data reflecting the so-called amateur prices, which are relatively high, and occasional, relatively low prices. This means that the seller is not looking to find an exceptional amateur in the real estate business who is ready to pay more than others, whereas the buyer is not seeking exceptional opportunities, i.e. the real estate is being sold under

compulsion. The standard not only presented an extensive definition of the market value, but also its interpretation. It was still relatively narrow, which certainly lowered its practical usefulness.

The standard provided, i.a., as follows:

- The valuer should assume that the sale of the real estate takes place at the date of valuation, the determined value of the real estate has to reflect the condition of the market at the valuation date and correspond to the price at which it could be traded when finalising the sales contract, and during the real estate market exposure period as well as in the course of the contract negotiation period the prices did not change.
- The valuer should not increase the determined market value of the real estate by the amount equal to taxes and fees, which the potential real estate buyer will be obliged to pay in connection with its purchase, in particular VAT.

An extremely important provision of the standard was the following one: “Market value should determine the expected value which the real estate may obtain for its use other than the current one at the valuation date, if there were offers to purchase this real estate on the market for another specific use” [19, p. III.1/2 – transl. from Polish].

With reference to this provision, five types of market value were distinguished:

- 1) market value for the current use,
- 2) market value for alternative use,
- 3) market value for optimal use,
- 4) market value for a forced sale,
- 5) market value for future sale.

The choice of the market value determined by the valuer resulted, in particular, from:

- the provisions of the contract with the party requesting the real estate valuation report,
- the purpose of valuation,
- the condition of the real estate market and the specific determinants of the particular real estate.

Each type of value was additionally explained in the standard [19, pp. III.1/3–III.1/8]. Market value for the current use was determined having adopted that the real estate would continue to be used in accordance with its present use. It took into account changes in value related to adding a superstructure, reconstruction of buildings and the development of undeveloped land. The authors of the standard stated that this type of value may be used “particularly in the valuation of a real estate occupied by an enterprise for its own purposes, assuming that the enterprise will continue its operations in the foreseeable future” [19, p. III.1/3 – transl. from Polish].

In accordance with the definition, market value for the alternative use reflected the prospective real estate use for the purposes other than the current ones. Market value for optimal use referred to a specific variant of market value for alternative use [19]. It consisted in determining value having adopted the additional condition of the most effective and best use of the real state, which is realisable and legal, physically possible, financially feasible and offers the highest value. It should be primarily used in the valuation of undeveloped land intended for development purposes.

According to the standard, when specifying values for alternative and optimal use, the valuer had to rely on specific information or data to justify its use. He/she could not make unfounded or unrealistic assumptions.

In practice, the first three types of value were accepted, the other two, which deviate from the assumptions of the market value definition (abandoning the assumption of concluding the transaction without compulsion and also the one that the value is determined at the date of valuation), were not approved by valuers. One of the arguments was certainly the difficulty in determining and justifying the result of the valuation. The second was that they could hardly be considered the market value.

The value reflecting current use was considered the priority from the first three types of value. From the perspective of almost 20 years, part of the professional community in Poland is aware that the concept of market value for the current use was not properly understood in Poland and was also misused in practice. At that time, we did not understand the above presented interpretation that this type of value could be used: “primarily in the valuation of real estate occupied by an enterprise for its own purposes, assuming that the enterprise will continue its activities in the foreseeable future” [19, p. III.1/3 – transl. from Polish]. This concept was intended to determine value for the financial statement purposes. However, this provision appeared at a time when there was no obligation in Poland to prepare a valuation for this purpose. In practice, the widespread acceptance of valuation for current use must have resulted in underestimating value of the appraised real estate, as well as the obtained transaction prices. It also had one more serious effect – it made valuers accustomed to approving the current condition of the real estate in the process of its valuation.

**The third stage, defining the market value, was provided in 1997** by the Act on real estate management [20]. In Art. 151(1) of the Act, the legislator stipulated that market value stands for

[...] the expected price at which the real estate can be traded, determined considering transaction prices obtained under the following conditions:

- the parties to the contract were independent of each other, did not act under compulsion and had a firm intention to conclude the contract,
- the time necessary for the real estate market exposure and for negotiating terms and conditions of the contract has passed [20 – transl. from Polish].

This definition only apparently reflected the concept of value presented in the standards of professional valuation practice. The seemingly small changes

introduced by the legislator meant that it could not have been considered the definition of market value, for the reasons listed below.

Firstly, it did not take into account the fact that valuation is interpreted twice: as the process of achieving value and as the effect of this process, i.e. value. The statutory definition was embedded in the process of reaching value and pertained to the valuation methodology rather than the result of this process, i.e. value. The legislator referred to comparable prices and, at the same time, used the past tense to define the market conditions of the transaction: "... the parties were", "... the parties did not act", "... they had". This provision still referred to the valuation methodology and required clearing market information of the prices which did not meet these conditions, i.e. were extremely low or extremely high. According to the IVS, valuation is not only understood as the process of achieving value, i.e. a set of actions taken up on the market, but also as the effect of this process, i.e. value. The legislator, having focused on the process, did not define value as a hypothesis of the price at which a real estate can be traded, but adopted that in the transaction for the purposes of which such a property is appraised, the definitional conditions referring to the behaviour of the parties as well as the expiry of market exposure and negotiation period will be met. To sum up, it was a mistake to use past tense and refer to the comparable prices. Using past tense is not correct because value, as the most likely price, relates to a future transaction and, therefore, it has to specify future terms and conditions of its conclusion. It means that a certain value can be considered the most likely price if the parties to this future transaction are independent, do not act under compulsion and have a firm intention of concluding it.

Secondly, it did not refer to the need for determining value as at the valuation date, which is a significant substantive flaw. Value, regardless of the area in which this concept is used, remains dynamic at all times, i.e. subject to continuous fluctuations. A clear-cut date, at which it is specified, is required to determine it.

Unfortunately, all the attempts to correct the legal definition voiced by a minor part of the professional community did not result in any effect. The professional organization did not comment on this matter, which may suggest that practitioners consider the valuation methodology more important than definitions, they use the category of value reflecting upon its essence.

**The four stage was initiated in 2005** with the seventh edition of International Valuation Standards, which implemented the requirement to determine market value following the assumption of the "highest and best use", referred to in the Polish source literature as the most advantageous use. The concept of optimal use was recognized as a fundamental and integral part of the market value appraisal.

The International Valuation Standards Council (IVSC) obliged member countries to adopt and follow the definition and interpretation of market value: "Member organizations are required to notify the IVSC of any significant differences between the national and international standards so that the international community can then be informed of these differences" [14, p. 24 – transl. from Polish]. The Committee

decided that in the event of “[...] discrepancies, valuers should calculate and explain the resulting differences in value” [14, p. 28 – transl. from Polish].

Organizations such as RICS and TEGoVA recognized that the optimal use concept places the category of value under too severe constraints. Real estate market participants also perceive the potential of real estate, confirming it in the prices of concluded transactions, in spite of no legal permission to use this potential. Since valuation is supposed to reflect the market, it seems that the concept of “hope value” shows its participants behaviour well enough.

After the publication of IVS 2005, introducing a single market value based on the assumption of the “highest and best use”, the professional community in Poland started to develop a new professional standard – *Market value and replacement value* [21]. In accordance with the standard, market value was defined as:

[...] the estimated amount for which a real estate can be traded at the valuation date, assuming that the parties have a firm intention to conclude the contract, are independent of each other, act knowledgeably and prudently, are not under compulsion, and the appropriate period of the real estate market exposure has passed [21, pp. 2–3 – transl. from Polish].

It appeared that not only adopting the definition, but also its interpretation, including the concepts of the most advantageous use brought about strong resistance in the professional environment. The difficulties in accepting the new concept are evidenced by the time spent on developing and adopting the standard by Polish Real Estate Federation as well as the heated discussions in the professional press. The standard was adopted by the National Council of PREF no earlier than in 2009. The attempt to implement the new interpretation of market value in Poland in the form of the *Market value and replacement value* standard [21] received harsh criticism. It was argued that:

- The assumption of optimal use is contrary to the legal regulations which in many areas, e.g., for compensation purposes, require determining market value for the current or alternative use.
- The requirement of determining market value for optimal use is inappropriate. For example, when purchasing a single-family house, real estate market participants do not consider the possibility of its superstructure, so these behaviours do not entitle the real estate valuer to seek an optimal way of using it.
- Optimal use is an imaginary way of future use and remains inconsistent with the principles of valuation taking both a comparative and an income-oriented approach. In the case of comparative approach, this assumption would require manipulation in the selection of comparable real estates or applying some additional “optimality factor” in the comparison procedure. Also in the income approach, it would mean the need to determine market value in each situation having adopted the real estate best use.
- The best use is a problem for owners and, possibly, investment advisors, because it is difficult for a valuer to check the actual demand for the purchase of a given real estate for the most advantageous use and determine when and under what conditions such use can be implemented.

- Adopting an optimal use for securing the lender's claims will lead to an increase in the pool of outstanding loans and may result in a crisis, as evidenced by the recent global financial crisis.
- Investigating the best use is not justified in Poland because of the low share of country area for which local spatial development plans are prepared.

The presented reservations prove **no understanding of the market value concept as well as the principles of the real estate market functioning**, for the reasons listed and discussed below.

First, the assumption of the "highest and best use" is not a defining element of market value, but an element of its interpretation alone. This means that adopting the most advantageous use concept is not inconsistent with the legal definition of market value, nor does it have to be inconsistent with the legal requirements in these areas where the legislator distinctly indicates the need for adopting a different assumption, because the valuation standards, both at the European level (EVS) and the international one (IVS) clearly emphasize that valuers should apply the definition of market value, unless the legislation provides otherwise [22, pp. 11, 23, 31]. It means that the new interpretation of value does not interfere with the valuation in the areas regulated by specific assumptions related to determining market value, e.g., for compensation purposes.

Secondly, valuation must reflect the behaviour of market participants along with the "highest and best use" principle guiding these market participants. It is evidenced by the following behaviour of market participants creating both supply and demand:

- Sellers' behaviour: real estate owners, putting their properties up for sale, sell the potential ingrained in them, e.g., the sellers of a post-industrial property know that it will no longer be used for this purpose, that the buyers – in addition to renovation and modernization – will adapt it to a different function, the function that will result in its higher value. The sellers, being aware of the potential inherent in the traded real estate wish to participate in the benefits resulting from such potential.
- Buyers' behaviour: real estate buyers, when calculating the maximum price, they are able to pay for the land, take into account its potential, frequently the potential that can be created in the future. The valuer, in the valuation process, only confirms the already existing market potential. He/she does not create it, as that would remain inconsistent with the essence of valuation, which involves searching for the value that objectifies the market, the value determined based on the prevailing market data. Some real estates do not have a market value for the current use, because no one will buy them for the continuation of their present function, e.g., the industrial function. If there is no market for the real estate at its current use, it will be necessary to look for another way of its development.

The above means that the sellers assess the purpose for which the buyers are going to buy the real estate. The demand reported by buyers depends not only on the current prices but also on the non-price factors, such as, e.g., expectations for the future, including the possible changes in the real estate use.

Thirdly, searching for the most advantageous use does require the adoption of a different use than the current one for each individual real estate. A single-family one-storey house or a one-storey house with a loft, located within a residential estate of single-family houses cannot be appraised having assumed a superstructure will be added or its function will change, e.g., into an office. This does not confirm the predominant behaviour of market participants. Currently, on the Polish market, buyers are looking for small, single-storey houses or possibly with a usable loft. If any of them can be remodelled after the purchase by adding a superstructure or changing the function (from a residential one into an office), it will not disclose the prevalent behaviour of market participants, the mapping of which cannot constitute the basis for determining market value, but rather the individual value. For most properties, their current use reflects the most advantageous use. It is estimated that 95% of residential real estates are characterised by the best use [24, pp. 167–169].

Fourthly, nor can one agree with the statement that it was the concept of the “highest and best use” which brought about the US mortgage crisis, turning into the global financial crisis and hitting the real economy on a global scale. Firstly, because a real estate valuer certainly quite rarely looked for a different method of use in this market segment, recognizing that the current use is the best one, and secondly, the source literature documents that one of the basic reasons for the crisis was the banking sector deregulation, where credit risk was poorly managed at the stage of assessing customers’ creditworthiness, their credibility and also the quality of the real estate accepted as collateral. This sector did not meet the expected ethical requirements: it was interested in granting as many loans as possible and of the highest possible value. A survey covering 500 valuers in 44 states revealed that 55% of them experienced pressure from the lender to overrate their property value in the period when the number of granted loans increased; 25% were subject to such pressure when preparing at least half of their commissioned valuations. However, as Stiglitz argued, “[...] if you earn money that allow you to settle for the rest of your life, there are no limitations to acceptable behavior” [25, p. 103]. The valuers’ refusal to overrate their valuations triggered banks’ attempts to set up their own valuation companies. The valuers employed there can no longer be regarded as being independent experts.

Fifthly, it is also unfounded to support the statement, often repeated by the advocates of the domination of law in valuation in Poland, that searching for the highest and best use is impossible in Poland due to the low share of the country area for which local spatial development plans are prepared. Market analysis shows that the lack of local plans is not an obstacle for investors (developers) in achieving their investment plans. The absence of local plans will certainly extend this process,

however, will not prevent it. An investor, at his/her own expense, will make a change or lead up to the local plan development. It is the observation of the market that allows a valuer to reproduce investors' behaviour presented so far. The price which the buyer intends to pay for the real estate is based on his/her conclusions as to the best use of the property [8, p. 67]. In the course of the valuation process, the valuer replicates the prevalent behaviours of market participants, by no means does he/she create them. If the real estate being appraised is purchased by an investor or a developer and their development vision differs from the assumptions made in the valuation process, it does not mean that the valuation was carried out incorrectly. It was based on the assumptions about the typical behaviour of market participants presented so far. There may always appear an investor (developer) on the market who will discover even greater potential than the current participants. His/her vision of development allows achieving additional value being an expression of his/her creation of an individual value, higher than the market value. This was the case of an Australian developer who purchased a post-industrial property in Lodz, built up with constructions covering the area of over 40,000 m<sup>2</sup>, entered into the register of monuments. The developer took up efforts resulting in the adoption of the local plan and adapted it for a residential function (lofts). It was an innovative function on the market. In the valuation process – based on the previous behaviour of investors – the real estate was appraised assuming its office and warehouse functions, because such market evidence was available to the real estate valuer. Even if the latter had any idea of how this property would be used by the future buyer in the course of the valuation process, he/she would not be able to include it in the assumptions made for the valuation purposes because it was not confirmed by the market. This means that the application of the best use principle is based on market experience and requires understanding the market participants' behaviour indicating the need to reproduce it in the valuation process.

The definition presented in the standard was not accepted by the legislator. No consistency, in the professional environment, with the interpretation of the market value presented in the *Market value and replacement value* standard [21], and the reluctance shown not only by the discussion participants but also by many representatives of the profession having concerns that “the new comes knocking at the door”, resulted in its withdrawal. It should be considered a great failure of the environment and discrediting in the eyes of the legislator.

**The fifth stage was implemented in 2017**, when the National Council of the PREF, at the meeting held on March 27, 2017, approved the *Market value* standard, which was included as the Basic Standard in the Framework of the General National Valuation Principles (currently PREF Standards of Professional Appraisal Practice). This standard was recommended for application since April 10, 2017. The professional community reacted to the provisions included in the Regulation 575/2013/EU on prudential requirements for credit institutions and investment firms [11]. The regulation introduced and defined two types of grounds for securing claims: market

value and mortgage lending value. Due to the legal nature of the Regulation, the definition of market value, in line with the definition provided in the EVS<sup>2</sup>, became an element of binding law in the Member States, therefore it has also become the law taking effect in Poland. The legislator introduced a new definition of value in August 2017 [26]. Unfortunately, this change did not result from common, internal arrangements, it was forced by the EU law, and the justification for the introduced amendments indicates that their essence was not understood.

A comparative analysis of both definitions leads to the conclusion that the concept of market value of a real estate is the same in both legal acts, while the Polish definition includes an additional methodological element concerning the application of a comparative approach. The definition presented in the EU regulation refers to the activities performed by the credit granting institutions and investment firms for the purposes of which real estate valuers determine its market value. The obligation to apply the above-mentioned definition results directly from the aforementioned EU regulation, however, only to the extent indicated by the provisions of the EU regulation. In the remaining scope, the definition resulting from Act of August 21, 1997 on real estate management is used. The intention of the project initiator is, however, that regardless of the real estate valuation purpose, one definition of market value referring to a real estate should be used. Therefore, the proposed amendment is not intended to transpose the EU regulations into Polish legal order, but to unify the concept used in the areas other than the EU regulation regarding the concept defined in that regulation for a narrow market area [27, p. 9 – transl. from Polish].

After the amendment to the Act on real estate management entered into force, the *Market value* standard was adopted by the National Council in September 2017.

## 6. Conclusion

The awareness of the historical context underlying the concept of value, as well as its complexity in the field of economics, is essential for correct understanding of this category and its proper application in practice. It highlights that this category was not only updated but also redefined. It took a long and painful process to arrive at the current definition and interpretation. The presented discussions prove that referring to the legal definition of value is not enough. It is a highly complex and fragile category. Underestimating the complexity of this category in the area of valuation opens a path for investigating simple procedures, even instructions, using which one can quickly and seemingly professionally “determine” the value, and also for seeking security in legal regulations instead of mapping the complex market reality. The economic roots of the concept of value prove that legal definitions of value can only be of a secondary rather than primary nature. The complexity of this category means that it cannot be left in a narrow, legal definition formula. If, in the minds of valuation practitioners, this category is poorly defined, one can hardly expect that the level of value will reflect the market accurately. The definition of market value

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<sup>2</sup> Definition compliance applies to the English version. Unfortunately, the official Polish language version lacks the last definition condition of value “the appropriate time of the real property market exposure has passed”.

is of a contractual nature, its current wording shows the present state of knowledge. The concept of value may evolve.

Firstly, this is because it covers all the assets rather than real estate alone. Objections are raised that it does not take into account the uniqueness of the real estate market. It is based on many simplifying assumptions which do not reflect the conditions in which this market participants are functioning, such as:

- The occurrence of static market equilibrium (the presence of a buyer and a seller). Dynamic equilibrium is taken into consideration in the real estate market.
- Rationality of the procedure.
- Access to full market information (the real estate market includes those better and less informed, with the latter constituting the majority).
- Recognition that the valuation date is the date at which the valuation objective is achieved.
- Searching for the most advantageous use. Finding it is blocked by the low operational efficiency and allocative efficiency of the real estate market. Operational efficiency refers to the choices allowing decisions to be made at the lowest cost (price). It is negatively affected by high costs of purchase – sale transactions, low real estate liquidity, its indivisibility, constancy in place and low market transparency. Allocative efficiency refers to the best use of the property. It has been recognized that the information available for an investor about the previously concluded transactions is insufficient to enable developing profitable investment strategies. The more limited access to information is, the more inefficient the market remains, and the probability of achieving an above-average profit grows.

Secondly, due to the changing external conditions. One can expect that the requirements of sustainable development may also have a significant impact. They result in economic consequences for value: on the one hand, the requirement to meet the highest environmental protection standards affects the durability of rental income, which reduces the risk of achieving them and has a positive impact on the level of value, on the other hand, it creates costs and brings about restrictions, which reduces the level of this value. However, the concept of sustainable development shows the need to consider the external effects of the actions taken at the level of determining market value or looking for additional value at the stage of valuation. Currently, EVS [17, p. 200] chooses the latter option – they point out that extending the concept of sustainable development will probably require the valuation of intangible assets, separated from the value of the main assets. As of today, there is an assurance that they will neither be a part of market nor fair value but it is possible that they may constitute an investment value.

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