

Profiting from Knowledge about Real Estate

The below article was written by Timothy Terrell, an associate professor of economics at Wofford College in Spartanburg, South Carolina. Reprinted with permission from The Free Market. For more information, visit www.mises.org.

Entrepreneurs are in a danger zone when their activities are incomprehensible to the general public. People begin to regard unexplained profits as suspicious, and the entrepreneur encounters public hostility. Entrepreneurs who assemble physical objects may find their activities transparent enough to avoid the torch-bearing mob, but beware of those who make a buck off information.

Consider used car dealers. These people essentially find buyers whom the sellers could discover only by incurring high costs. As a penalty for dealing in information, they share the social stratum occupied by sub-prime lenders, network marketers and TV faith healers. Anyone who profits only by gathering and using information, without changing the physical form of objects, risks the wrath of those who hold to what Thomas Sowell called the “physical fallacy” – that value is only created when an object’s physical properties change.

Flipping Real Estate

Real estate investors have come under fire for the common practice of “flipping” a property. An investor finds a seller who is willing to sell for a low price (perhaps because of imminent foreclosure or to gain immediate cash to pay other debts), then immediately attempts to resell the property to a third party. It’s the day trading of the real estate world, with advantages to those familiar with real estate law, finance and the nuances of local real estate conditions.

If extensive repairs are done to the property before the resale, the flipping becomes the slightly more respectable operation called “rehabbing”. Perhaps the flip includes a new coat of paint or a little landscaping, but otherwise it may not involve much physical change in the house.

The profits from flipping or rehabbing – and they can be substantial – accrue to those who are able to match willing sellers with willing final buyers. An acquaintance of mine learned of a house he could purchase for less than \$20,000, which he put under contract sight unseen. On his way over to the house, he contacted a potential buyer, had the buyer meet him at the house and sold it on the spot for \$70,000.

Those who appreciate the entrepreneurial knack for handling disparate pieces of information can marvel at the skill and cleverness of such investors. Yet the quick profits that sometimes accompany real estate investing attract equally quick condemnation.

Mob Wants to Stop You!

Around the country, a suspicious mob is gathering and they are lighting their torches. Several years ago, the Department of Housing and Urban Development (HUD) passed a rule penalizing property owners who resell their properties within a short period of time, citing concerns about property flipping. (The penalty is a restriction on obtaining mortgage insurance from the Federal Housing Administration.)

A September 2006 entry on a Western New York political blog was headlined “Federal Leadership Needed to Combat Property Flipping.” The targets were “absentee landlords” and “speculators,” alternately referred to as “slumlords and shysters.”

Last year, a Georgia congressman introduced H.R. 200, the “Prevention of Predatory Lending through Education Act,” which supported HUD in its desire to restrict or ban loan “flipping.”

Free markets do not guarantee freedom from fraud and there are in fact a few slimy real estate investors who will lie and steal. The state thus gets its foot in the door, although anyone paying the least bit of attention would note that the state itself habitually lies and steals, under the direction of truly slimy politicians. Only a little actual fraud will suffice to justify clamping down on the entire industry. Proposed legislation regulating real estate flipping in North Carolina was based on three cases of fraud in the state, a tiny fraction of a large real estate market.

Even some nonslimy real estate investors are burdened with guilt over their occupations. One wrote that he was concerned that certain types of real estate investing might violate laws like the Texas Deceptive Trade Practices Act. This law (Texas Business and Commerce Code Section 17.45) prohibits “an act or practice which, to a person’s detriment: (A) takes advantage of the lack of knowledge, ability, experience or capacity of a person to a grossly unfair degree or (B) results in a gross disparity between the value received and the consideration paid.”

Unfortunately, this sort of law is so ambiguous that it is worse than useless. If the sense of the law is merely that the contract should communicate clearly what is to be traded, under what terms, and for what payment, the law may be innocuous enough. But it seems to say much more than that.

What’s “Unfair?”

Since all transactions involve unequal knowledge (and opinion) between buyer and seller, who is to say what is “unfair”? This leaves all transactions open to potential cancellation by the state, should the court decide that the inevitable inequality of knowledge was great enough to warrant intervention.

The second clause in the Texas statute could be equally damaging to the security of any contract. All transactions occur where there is a disparity between the value received and the consideration paid – and who is to say how much is a “gross” disparity? This problem emerges from a fundamental error that has plagued economic and political thought since Aristotle, at least.

Murray Rothbard, in his *Economic Thought Before Adam Smith*, explained Aristotle’s misunderstanding of exchange: “Aristotle says that in order for an exchange ... to take place, the diverse goods and services must ‘be equated’, a phrase Aristotle emphasizes several times ... His reasoning was that for A and B to exchange two products, the value of both products must be equal, otherwise an exchange would not take place. The diverse goods being exchanged for one another must be made equal because only things of equal value will be traded.”

The Aristotelian concept of equal value in exchange is just plain wrong, as the Austrian School was to point out in the late nineteenth century. If A trades shoes for sacks of wheat owned by B, A does so because he prefers the wheat to the shoes, while B’s preferences are precisely the opposite. If an exchange takes place, this implies not an

equality of values, but rather a reverse inequality of values in the two parties making the exchange.

If I buy a newspaper for 30 cents I do so because I prefer the acquisition of the newspaper to keeping the 30 cents whereas the news agent prefers getting the money to keeping the newspaper. This double inequality of subjective valuations sets the necessary precondition for any exchange.

Knowledge is Power

So what of the person willing to sell their home for \$20,000, when a real estate investor believes there is a reasonable chance of getting \$70,000 for the house? There is certainly a disparity of information. The seller may not know market prices for similar houses and may not know where a person willing to pay \$70,000 may be found.

If rehabbing is necessary to bring in the \$70,000 price, the seller may not know what contractors would do the work well and without fraud. This is valuable information which the investor may have obtained only through years of experience in the business. It may have taken years of trial and error to find realistic appraisers, sources of financing, reliable and low-cost contractors and efficient methods for reselling the house. To argue that the buyer is under obligation to reveal all this to the person willing to sell at \$20,000 is to argue for a communism of information.

The home owner may be willing to sell at a steep discount in order to pay off the mortgage to avoid imminent foreclosure. For whatever reason, the owner wants liquidity and is willing to make a large sacrifice to get it. It may even be the case that the home owner knows more about the neighborhood than the real estate investor, so that what looks like a steep discount to the investor is no discount at all.

Speculators Benefit Society

In the process of buying, fixing up, and reselling properties, real estate investors tend to leave neighborhoods much improved. This is urban renewal free-market style, in which property is paid for at a price voluntarily agreed to by the seller, not condemned or designated as “blighted” by the city and seized.

One real estate investor I know purchased a house from an absentee landlord whose drug-abusing tenants (relatives of the landlord) had completely trashed the house. Rotting mattresses, filthy clothing and broken furniture cluttered the bedrooms. Chunks of daylight were visible through the ceiling and the walls looked structurally unsound. There was a rodent infestation problem.

The house was so unlivable that the tenants had apparently remained out of doors as much as possible, judging from the table and chairs in the front yard. My real estate investor friend bought the house, gutted it to the studs and turned it into one of the most valuable houses in the neighborhood in about a month. The neighbors were delighted since it removed an eyesore and increased the value of their homes.

Real Estate Bubble?

Some observers have remarked that increased “flipping” activity is a marker of a real estate bubble. I doubt that is true for rehabbing, but it may be true for plain flips, just as the departure of employees to full-time day trading was an indicator of an overblown stock market in the late 1990s. Turning \$20,000 into \$70,000 in a couple of hours may

be more common during a bubble and it might be more reasonable to expect real estate investing to revert to modest profit levels as real estate values settle.

Excessively “creative” financing schemes used by investors to buy real estate may turn out to be the real estate equivalent of buying stock on margin using a credit card.

However, even though the Federal Reserve’s monetary excesses may occasionally lure too many into day trading and real estate investing, both are worthy entrepreneurial activities. There is nothing inherently slimy about trading real estate and certainly nothing warranting the state’s regulation of this market.