Analyzing the price of art

In *The Art Newspaper*[1]s April issue, the Italian economist Guido Guerzoni criticised art indices on various (not always incorrect) grounds. His arguments are that: (a) price indices are based on auction data, which account for a mere 25/30% of the market, and do not take into account sales by dealers (70/75% of the market); (b) many of the calculations are based on a technique that considers only resales of identical works, and so does not use information from all other sales; (c) the bulk of art sold at auction is bought by intermediaries and not by the people who end up actually owning the works; (d) an investor wants to know whether the profit goes to the artist, to a dealer or to a collector; (e) most indices do not take into account the transaction costs of buying and selling works of art; (f) most price indices examine only paintings, and are thus not representative of the art market as a whole; and (g) economists rely on “an abstract, theoretical model” to produce their indices. Let me take each criticism in turn.

Prices indices are based on auction data

It is certainly true that most indices are based on auction prices. The obvious reason is that dealers do not disclose their prices, and it would make little sense to base an index on the prices that only a few dealers would be willing to supply. Such indices would be unverifiable, and one of the golden (and reasonable) rules in applied science is that results should be reproducible. You may say that since 70% of the trade goes through dealers, economists miss the point, and look for their keys under the streetlamp, not because they lost them there, but because the light helps them to see. The alternative, which seems to be suggested by Dr Guerzoni, is not to look at all. I do not think this is any better. Moreover, I believe that auction prices help and guide dealers in setting their prices, certainly for similar works and artists that are sold at auction, and even for others, since these prices provide yardsticks.

Only resale data is used

I think that this argument is not valid. The reason why some economists say this is that the objects sold are heterogeneous. Even two paintings by Picasso sold at the same or different times are not comparable. Limiting the computation of indices to works that are sold twice eliminates these differences, and the computation is (roughly) based on average rates of return of identical works sold at least twice (which makes the return easy to compute) over a specific time span. There exists, however, an alternative, though far from perfect, method that enables the “homogenisation” of different Picassos, and it has recently been shown that the two methods provide very similar results. This hedonic method takes into account all the sales (at lower cost than the other); in addition, the so-called “repeat-sales” method (which only uses works sold twice) gives good results as long as the number of works that are sold twice is large enough.

Art is sold to intermediaries

So what? Would dealers buy if they were not able to sell to final clients? If so, they would all be bankrupt before long. Dr Guerzoni seems to be pointing out that works are eventually sold to the final client at prices that are different from those obtained at auction, and is, therefore, questioning the usefulness of indices based on auction prices. This is a good point. However, sometimes the price will be larger, and occasionally smaller, so that on average, it will make little difference. If the price were always larger, all dealers would make profits, and the sector would be open for more and more new entrants, driving profits to zero because the demand is limited, so that, again, the prices at which the works are sold would not differ too much from the prices paid at auction. We are back to square one: auction prices are a reasonable indicator of what happens in the art market.

Where does the profit go?

An investor wants to know whether the profit goes to the artist, to a dealer or to a collector. Why would the investor care? When I buy a car, or a cookie, I am not interested in knowing what the trade margin of the dealer is. I just ask myself whether the thing I want to buy is worth owning or eating and whether my budget allows me to do so.

Indices do not reflect the costs of buying and selling art

I cannot disagree with this point, but it is impossible to take into account. If the buyer sells one year after having bought, he will indeed incur the very high auction house commission (say 25%), and this will reduce his yearly rate of return by 25% But if he keeps the work for 25 years, its rate of return will roughly be reduced by 1% per year. How can the economist who computes indices take this into account? The only thing that he can, and should, do is to warn that transaction and other costs should be deducted from the annual return generated by the index, and give an idea how to proceed.

Indices only cover paintings

It is true that more research is devoted to paintings, but specialised journals contain information about other markets. Such indices can be computed‹if someone were willing to pay for them.

An abstract theoretical model

I seriously dispute this idea. The model used to derive such indices is neither abstract, nor theoretical. It is straightforward statistics or econometrics, and easy to explain to the layman. The index must be credible and this brings me back to a point that I made earlier. In order to be credible, an index must be verifiable by others, and for this to be the case, we need public data, so that various methods can be used to check whether they lead to similar results or whether one of these is indisputably better than the rest, and should be adopted by all.

Let me conclude by stating that economists have done their best to provide information on art markets. They cannot be blamed for not extracting information from data that they do not have. The only alternative proposed by Dr Guerzoni is to do nothing, thus jumping from the frying-pan into the fire. But I agree that those who publish price indices should warn users that they contain some pitfalls. I am sure those users already know this.

Victor Ginsburgh
Professor of Economics, University of Brussels