

On optimal real estate commissions [☆]

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Received 28 September 2004

Available online 15 September 2006

Abstract

When real estate agent effort is unobservable, home sellers do not prefer the lowest possible commission rate because such a rate does not induce sufficient effort from agents. As a result, the optimal commission from the seller's perspective exhibits downward rigidity, even if there is free entry. The analysis shows that downward rigidity will occur if and only if the quasi-fixed costs of selling a house are small. © 2006 Elsevier Inc. All rights reserved.

JEL classifications: D82; D86; L15; L85

Keywords: Agency theory; Commission contracts; Real estate services

1. Introduction

The relationship between a home seller and a real estate agent is one that is wrought with incentive problems. Moral hazard may arise because the agent's effort is not verifiable, or because the agent has an incentive to provide the seller with inaccurate advice.² Of course, it is well known that contingent payment schemes can help alleviate moral hazard problems, so it no surprise that sales commissions are the dominant form of compen-

[☆] We are grateful to Don Clark, Dino Falaschetti, David Robison, and Denise Stanley for helpful comments on earlier versions of this manuscript.

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² See Yinger (1981); Zumpano and Hooks (1988); Arnold (1992), and Anglin and Arnott (1991).

sations for real estate agents. This paper analyzes the optimal sales commission from the perspective of the home seller when agent effort cannot be verified, and derives the conditions under which the agent can earn informational rents despite an otherwise competitive market in real estate services.

Buyers in most markets prefer lower prices, but this is not true in markets with asymmetric information. When it is not possible to contract on effort (because it cannot be verified), a home seller faces a tradeoff: a smaller commission allows the seller to keep a larger share of the sale price. However, the agent provides less effort at a lower commission increasing the expected time the house is on the market. The optimal commission rate must balance these two considerations. As a result, a *home seller* may prefer a higher rate to a lower one because low rates fail to induce sufficient agent effort.³

An important implication of our analysis is that real estate agents can earn informational rents on house sales even if they behave non-cooperatively as long as the quasi-fixed costs of selling a house are small.⁴ In other words, the optimal commission rate will typically lie above an agent's reservation rate. Competition does not remove the rents because the home seller is worse off at lower commission rates. It is often suggested that commissions are too high for a competitive market (see, for example, Yinger (1981) and Anglin and Arnott (1999)), but our model shows that above-normal commission rates are consistent with a high degree of competition.^{5,6}

In practice, commission rates typically fall between 5% and 7%, with 6% being by far the most common. Though it has become something of a stylized fact that real estate sales commission rates are uniform, recent studies (for example, Sirmans and Turnbull (1997)) suggest otherwise. In fact, the most recent evidence suggests that the average real estate commission rate in the US is down to about 5.1 percent from historic averages around six percent (Hagerty (2004)). One might speculate that the advent of new technology such as the internet and a possible decline in information asymmetry are responsible for the fall in rates. Our model does not predict uniform commission rates. On the contrary, the optimal commission rate, in principle, depends on the exact characteristics of a given house and relevant market. We are aware of no other theoretical research that predicts the same commission rate for different houses and different markets.

Finally, let us point out that in many circumstances the first-best contract requires that the agent purchase the house and then resell it using the optimal level of effort (Shavell, 1979). However, as discussed by Anglin and Arnott (1991), such contracts

³ Our story is similar to the efficiency wage theory which postulates that employers may find it optimal to pay wages in excess of employees' reservation wages when monitoring is either costly or imperfect (for example, see Shapiro and Stiglitz (1984)).

⁴ Yavas (2001) shows that "the prevalence of fixed costs...in the real estate brokerage industry makes it impossible to have competitive commission rates as the equilibrium outcome" (page 187). However, unlike the present analysis, Yavas does not allow for unobservable agent effort.

⁵ The most common explanation for the rigidity is that collusion of some sort (tacit or explicit) is at work. Zumpano and Hooks (1988, p. 3) write that "from the very inception of what might be called the modern real estate brokerage industry price competition was discouraged by explicit price-fixing agreements maintained by local boards of realtors."

⁶ Santore and Viard (2001) use a similar model in which contingent fees for attorneys exhibit downward rigidity. The purpose of that paper, however, is to explain the American Bar Association's prohibition on the purchase of legal claims by attorneys.

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