

# A Critical Assessment of the Traditional Residential Real Estate Broker Commission Rate Structure (Abridged)

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This article began as a footnote to in his 2000 analysis of how new communication technologies can dramatically improve the consumer product selection process.

Competitive pressures ordinarily force providers' prices to reflect their cost structures. Standard, traditional real estate broker commissions, however, are strangely unrelated to either the quality of the service rendered or the value provided. This article analyzes five separate elements of the traditional residential real estate broker rate structure and reveals why the traditional percentage-of-sale-price fee formula does not serve the interests of home buyers and sellers. The article concludes by suggesting four short questions that home buyers and sellers should be encouraged to ask about broker fees and services. These should help brokers offering the flat or hourly fees and performance-based bonuses, which best serve consumers, to overcome the anticompetitive obstacles that traditional brokers have maintained to protect themselves.

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## I. Introduction

Residential real estate brokers and salespersons (agents of brokers) have long quoted their fees as a straight percentage of a home's sale price. This traditional formula, however, ill serves the interests of both home buyers and sellers, and is a primary reason why such fees may be inflated by \$30 billion annually.<sup>1</sup> Although competitive pressures

<sup>1</sup> Broker commissions were approximately \$65 billion (in 2005) and it is suggested that the annual broker fees consumers might save if there was effective price competition is as much as \$30 billion. Hsieh & Moretti (2003: 116) estimated that the social loss represented more than half of the total commissions earned in 1990, this indicates that more than half of current commissions might be eliminated by competition. Ham & Atkinson (2003: 2) estimated the total excess charges to home buyers for brokerage mortgage, and related services at \$39 billion annually, about \$14 billion for real estate agents services. Delcours & Miller, (2002: 29) found that U.S. broker fees should equal something closer to three percent



in an industry ordinarily force competitors to adopt fee structures that reflect their costs, this has not occurred for real estate broker fees. Despite intensely competitive local real estate brokerage markets, broker fees are usually set without regard to either the quantity or quality of service rendered. It is as if tax preparers set their fee as a flat percentage of a client's gross income, irrespective of how difficult the return was to prepare or how much their efforts saved the taxpayer. Furthermore, the fee formula creates very little incentive for agents to provide consumers with the full value-enhancing services that many could offer.<sup>2</sup>

A traditional seller's (or listing) broker will typically charge the owner of a \$200,000 residence a six percent commission to provide "full service." This generally includes helping to price the home, to "stage" it effectively, showing it, and negotiating with potential buyers, as well as handling the closing. Yet the listing broker usually retains only half of that fee (three percent) for providing those services and generally offers the other three percent to the broker of the agent who finds a buyer. Meanwhile, both brokers split their fees with their agents and the agents may end up with anywhere from about 40 to 100 percent of the commission. With a 70-30 split, the traditional listing agent will receive about \$4,200 of the \$12,000 commission on a \$200,000 home.

Brokers justify using a percentage-of-sale-price formula with the claim that it aligns incentives of brokers with those of sellers; yet under the splits just indicated, the listing agent will earn only 2.1 percent of any additional value he or she can create by increasing the sale price of the home. This is quite a weak motivator.

Meanwhile, despite being willing and economically able to provide full service for an average \$12,000 total commission, listing brokers commonly seek and receive many times that amount even when they expect to expend significantly less than the average level of effort and resources (and have a lower risk of failure). Thus, a seller's broker for a \$1 million dollar home is apt to charge a five percent fee (\$50,000), even when a hot market suggests that it will be easy to obtain the asking price or more, and the sale will require less than ten hours of work. Moreover, such brokers' agents commonly disparage brokers offering to provide full service for only a four percent (\$40,000) commission, implying that such discount brokers will have to skimp on service because it is economically impractical to provide "full service" for only \$40,000.

The situation is even odder for the agents who assist buyers. Certainly an agent with 30 years of knowledge regarding all aspects of the neighborhoods in a community may be worth \$500 an hour or more to help buyers find the home best able to satisfy all their future desires. Yet in other cases, astronomical fees are paid with little, if any, justification<sup>3</sup>. In addition, the formula induces buyers' brokers' agents to encourage their

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versus six to seven percent, implying excess fees of as much as \$30 billion or more annually. Lesly (1990) reporting that an FTC official reported being told by a former president of the California Board of Realtors that “2 percent is closer to what a competitive rate would be if there were not these artificial structures in the real estate industry”.

<sup>2</sup> A similar situation exists for mortgage broker fees. Guttenberg (2000, 2001).

<sup>3</sup> For example, i) even where buyers did all the searching on their own and called the listing broker, clearly stating that they did not want the assistance of a buyer's agent, if the listing agent's colleague answered their call and provided services normally provided by the listing broker, that agent's broker may demand and receive half of the six percent commission. (Evans 2005) ii) even when prospective buyers at an open house merely chat with the listing broker's associate (who may be one of the hundreds of thousands of novices, who have recently passed the state licensing exam after only 25 to 60 hours of study), that agent's broker

clients to make higher bids rather than trying to negotiate a lower purchase price.

In many ways, the residential real estate brokerage industry resembles the American funeral industry that Jessica Mitford (1998) expertly exposed in 1963 in *The American Way of Death*: Families arranging for funerals were regularly asked to pay a single price for a bundle of services, many of which they did not need or want. The words of a 1983 Federal Trade Commission (FTC) multi-year study of the residential real estate brokerage industry (FTC 1983: 11) still stand: “the market for real estate brokerage service does not accord with the customary model of competitively functioning markets.”

The strange nature of the fee structure has led the industry and press to report that average commission rates have “fallen” from about 6 percent to 5.1 percent between 1991 and 2004, although the average commission has *increased in dollars* over that period, even after adjusting for inflation. As an illuminating 2003 article by Hsieh and Moretti (2003) explained, the industry has channeled competition towards providing consumers with two, dubious benefits: 1) a surplus of new, inexperienced agents,<sup>4</sup> and 2) free promotional gifts, such as refrigerator magnets and the like, personalized with agents’ names.

Rather than focus on the commission rate level, this article is primarily concerned with why the traditional fee *structure* sets prices based solely on the sale price of the home, without consideration of either the quantity or quality of service desired. It views the industry’s traditional one-dimensional fee structure as very similar to the illogical, inefficient formula previously used by travel agents and stock brokers through the early 1970s – setting a fixed rate, which did not vary with the size of a sale (whether in dollars or shares of stock).<sup>5</sup>

The more recent transformation of travel agent commissions on air travel is probably most suggestive of the future for agents even though good real estate agents play a much greater and important role interpreting data for clients. That is, in the late 1990s the airlines began eliminating the ten percent commissions generally paid to travel agencies on airline tickets the latter sold. As a result, today most travel agents are forced to bill clients separately and explicitly for the research and ticketing services they provide.

## II. Charging a Percentage of the Sale Price of a Related Item

Most professionals, such as doctors and lawyers, set their fees based on the quantity and quality of their efforts. They charge hourly rates, although for many routine tasks, which normally require a fixed duration to complete, they quote a flat fee. This serves administrative convenience as well as buyer preference for certainty.

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may be entitled to receive a full three percent commission (Hagerty 2005) iii) Hagerty (2005) reported that a case where a buyer discharged her Nantucket buyer’s broker after he refused to accept a \$200,000 cap on his fee, and then used her lawyers to purchase a \$15.5 million home, the broker (who had introduced the property to her) still sued the listing broker for his half of the \$620,000 commission.

<sup>4</sup> The number of licensed agents reached a record high in 2005 with more than 2.6 million, and as many as 1.3 million active agents (Evans 2006)

<sup>5</sup> Stock broker commissions, however, began to be priced competitively in 1975, when the Securities and Exchange Commission ended its protection of fixed commissions and permitted order processing to be unbundled from research. Customers who did their own research increasingly opted for the dramatically lower prices offered for “no frills” service.

Under some conditions, however, service providers receive compensation based on other formulas, such as a percentage of the sale price of items sold or of funds recovered. In fact, according to the National Association of Realtors (NAR 2003: 6) about 90 percent of real estate brokers, including most buyers' brokers, are paid based on the sale price of a home.

Yet careful analysis of six rationales that justify percentage-of-sale-price rate elements for other service providers finds that none justify a straight percentage-of-sale-price fee for residential real estate agents.

## **A. Offering a Share of Incremental Value Produced Motivates Providers**

Many employers seek to obtain optimal performance by offering their salespeople commissions: a specific percentage of their total sales revenues. Yet, although salespeople are generally paid a percentage of the *sale price*, employers set commission rates based on the *incremental value* the firms gain from the sales. Unfortunately, in many cases, it is impossible to set a commission rate on total sales that represents a set percentage of the incremental value produced. It is certainly reasonable to motivate real estate listing agents by offering them a share of the incremental value that they can obtain for sellers. This incremental value would come in two forms: a net increase in the sale proceeds and a faster sale (if that was desired). In a stable market, incremental value might be measured from a baseline based on an average of some set of comparative market analyses; but this would be harder to measure in a volatile market. Rewards for quick sales might be measured against a benchmark of the average time comparable homes have taken to sell in the previous few months.

Sellers would generally want agents to take three actions to increase the net sale price of the property. First, they would want agents to make all cost-effective efforts to "stage" their homes to increase their attractiveness and lead potential buyers to offer higher prices. Second, they would desire optimal efforts to reach the maximum number of bona fide potential buyers via all cost effective media. Third, sellers want an expert's advice as to what price to set and whether to accept a given bid or to wait in hopes of a better offer. Although all three matter, most commentators have ignored the first when evaluating how well the interests of sellers and agents are aligned (the principal-agent issue).

Even a full three percent commission appears much too small to align the incentives of listing agents with sellers with respect to the seller's first two goals: investing optimal effort to maximize the value of the home and to market it. Consider a home with an estimated fair market value of \$500,000. Assume an agent expects that by doing a standard, satisfactory job she can obtain a \$500,000 offer. She also estimates that after spending 40 more hours on extensive staging, on carefully targeted marketing, and other enhancements, she will be able to obtain a bid of about \$540,000. Given the seller's strong interest in obtaining the highest price, one would expect the fee structure to strongly encourage the latter effort. Yet, under the traditional fee structure, the effort indicated would only increase the typical broker commission by \$2,400 and thus her net pay by no more than \$1,200, translating into \$30 per hour—a relatively weak incentive for an effort that generates \$1,000 per hour for the seller.

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To motivate agents to create incremental value, they should be paid more like 30 percent of any net price increase they can produce, and the percentage should go to the agent without any splits. But clients should not pay any percentage on the portion of revenues obtained that should be “easy” to secure. Rather, if a \$12,000 commission payout is sufficient to cover the standard costs to brokers and agents—including their time—to sell a \$200,000 home, it should be a sufficient incentive to motivate them to sell a \$400,000 or even an \$800,000 home, if they do not make any special efforts that produce incremental value.

Regarding advising a seller whether or not to accept a bid, a flat fee gives agents no incentive to recommend that a seller accept a bid that might be less than optimal, but a net three percent commission on the sale price also seems unlikely to create a sufficient benefit to outweigh the value to the agent of receiving a large fee without any further work. The value of quick receipt of a relatively large fee is likely to override the incentive to earn an additional small amount. To obtain more useful advice, a seller might offer the listing broker’s agent (alone, not split with any others), a substantial portion, e.g., 20 to 50 percent, of any increase in the sale price above some benchmark. The difficulty of setting that baseline, however, leads some to reject this approach.

Although a percentage-of-sale-price fee gives agents aiding buyers an incentive, albeit quite small, to act opposite to their client’s interests. That is to coax buyers to bid higher than justified. Therefore agents working with buyers should also receive only basic flat fees or hourly rates—but no bonuses—for efforts that produced no extra value, although “extra value” may be hard to measure in a sellers’ market.

In conclusion, the most appropriate fee structure for motivating agents to best serve home sellers would appear to consist of as many as three parts: 1) a base lump sum fee, based on the degree of difficulty given the state of the market and the skill of the agent for selling the home at an agreed upon minimum price (although it could also depend on the time required for the project); 2) a substantial percentage, e.g, 20 to 50 percent (for the agent alone), of any incremental value created in terms of securing a higher price for a seller (or a lower price for a buyer); 3) a specific bonus for securing a suitable deal by a deadline.

## **B. Provider’s Special Ability and Effort Justify an Equity Stake**

Some service providers have rare abilities that enable them to add great value to a customer’s project. They can convert an economic “rent” on their talents into an equity stake. Service providers in this group would include top sports or entertainment agents, whose credibility and relationships enable them to negotiate contracts for their clients with higher pay levels and special terms unobtainable by others. Top plaintiff tort litigators are also in this class—probably viewing their cases as personal projects.

This rationale for commissions would only appear applicable to real estate agents to the extent that it overlapped with their ability to produce significant incremental value. Those eligible would include listing agents with extensive files of (and relationships with) wealthy clientele apt to be interested in purchasing prime properties and less likely to consider the home if it were marketed by most other agents.<sup>6</sup> It could also

<sup>6</sup> Harney (2002) reporting that “one East Coast-based company that specializes in exotic, high-end properties that require lavish advertising outlays to reach small numbers of wealthy target purchasers averages . . . 11.8 percent [commission]”; Swartz (2006) discussing Janie Miller.

include agents who had a special plan likely to significantly increase the sale price of the home or any agent with more customers than time.

On the other side, buyers might offer large hourly fees or even percentage fees to bid for the scarce services of agents with such detailed knowledge of individual neighborhoods and residents that they would be uniquely able to help buyers identify the streets on which they would be most comfortable or know of relevant homes not yet on the market. This group might also include agents perceptive enough to quickly and accurately diagnose the buyer's needs and desires and thus the most relevant criteria for identifying the buyer's ideal home. While these providers might be able to demand a percentage fee, one would expect most of them to be equally comfortable with a very high hourly wage reflecting the value of their knowledge.

### C. Provider is Also Asked to Make a Substantial High-Risk Investment

In some cases, individuals are asked to provide a valued service even though their employers are unwilling or unable to pay them their regular price for those services. Service providers asked to make a substantial, high risk investment in the customer's venture can demand an equity stake.

Certainly some home buyers and sellers will fail to complete a transaction—and therefore produce no fee—but that does not give real estate agents the same status as those who take high risks on large investments. Competent agents should be able to quickly identify and avoid sellers who are seeking unreasonably high prices and resistant to appropriate price reductions. Similarly, agents should have little difficulty identifying buyers who are unrealistic about the market and terminate the relationship before making any large investment of time unless they are treated as co-investors.

Real estate agents do face a risk of non-payment by customers who, after milking them for lots of useful information or investments in marketing expenses, terminate their relationships before making a purchase or sale. Yet a percentage fee does not deter such free riding. The best way to address this problem might be for brokers to charge buyers and sellers some nominal flat retainer or hourly fee, or at least pre-payment of expenses, which would not be due until purchase or sale, but which would survive termination of the relationship.

“Real estate agents do face a risk of non-payment by customers who, after milking them for lots of useful information or investments in marketing expenses, terminate their relationships before making a purchase or sale.”

### D. Proxy for Provider's Costs or Efforts

Basing a service provider's compensation on sale price also makes sense if that sale price is highly correlated with the quantity or quality of service provided. For example, tips based on restaurant bills make some economic sense because higher bills generally reflect a greater quantity or higher quality of service or both. Yet while the costs to the service provider may increase on average as the revenues involved grow, that increase does not appear to be proportional to the revenues.

So what about the correlation between a home's sale price and a broker's costs in assisting the sale? It appears that most of the costs entailed in effectively selling a home are unrelated to the sale price and the remainder are as likely to be *inversely* as directly correlated to the price, at least for homes priced above the local median.

Brokers for sellers may assert that higher priced homes require more extensive advertising, more expensive staging, or the like, but this position is hard to defend. For example, buyers of average-priced homes are more likely to make a bid before carefully viewing the relatively large number of their options than buyers of higher-priced homes, having fewer options. Therefore, it is more important for agents representing average-priced homes to attract early attention from such buyers. A 2006 *Inman News* (2006: 7) survey of brokers found that the amount brokers “spen[d] to market listings doesn’t generally increase” with the price of the home. In fact, much expensive advertising may primarily benefit listing brokers in their efforts to place their names, repeatedly, in view of future buyers to recruit them as clients.

Three counter-arguments on this point also deserve a response. First, the higher priced homes will attract the most skilled and experienced (and implicitly expensive) agents. Yet those buyers or sellers might not need or want to pay high rates for expert advice. Second, higher-priced homes might remain on the market significantly longer than lower-priced homes, requiring more advertising, if not other effort, although the limited empirical data reported on such timing does not reach this conclusion.<sup>7</sup> Third, a relative scarcity of buyers for the highest priced homes might create a greater risk to agents of losing the listing to another agent or a “for sale by owner” (“FSBO”) before it sells.<sup>8</sup> Brokers might claim that this higher risk justifies a higher fee, but a shift among brokers is as likely to help as to hurt them and wealthier owners appear least likely to shift from a broker to a FSBO.

In conclusion, the cost of effectively marketing a home appears unlikely to correlate with the price of the home. Instead, it seems that brokers and their agents may spend more for marketing higher priced homes *because* they feel the need to justify the higher fee they will earn.

## E. Setting Fees Based on Wealth or Income

Income and property taxes and other fees to finance government services are generally set as a percentage of an individual’s or household’s income or wealth, but this approach is based on the political view that those with the highest incomes or wealth should contribute in proportion to that income or wealth. While public policies might justify a cross-subsidy from those most advantaged to those most disadvantaged, there is no reason to expect private entities to mimic these practices, absent price or profit regulation. In particular, there is no reason to believe that real estate brokers use the percentage-of-sale-price rate element to overcharge buyers and sellers of higher-priced homes so that they can undercharge buyers and sellers of lower-priced homes. Rather, such a pricing mechanism merely appears to confirm the market power that permits such value-based pricing.

<sup>7</sup> Hsieh & Moretti, (2003: 1111, 1113) found buyer agents appeared to spend more time aiding buyer searches for higher priced homes, although the relationship between price and search time appeared to be small.

<sup>8</sup> Gengler (2007) estimates that approximately 20 percent of sellers used the FSBO option in 2006 according to Real Trends data.

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## F. Avoiding Some Harmful Effects of Hourly Rates

Basing compensation on a percentage-of-sales-price also avoids some drawbacks of paying fees based on hours of input, particularly that the latter creates a perverse incentive—employees are encouraged to spend more time than necessary on a project and to overstate the time spent. Hourly rates may also deter customers from communicating freely because they feel that they are “on the meter.” Many sellers may be reluctant to pay for time to fully explain an important matter out of a false belief that it was not worth the cost of discussing it. Whatever the disadvantage of hourly rates, however, it is important to recognize that they can be avoided by employing any one of multiple alternatives, including flat fees.

## III. Sellers Set the Fees for and Pay the Brokers Assisting Buyers

The norm in retailing is for buyers to be advised by salespeople loyal to sellers. While the salespeople typically help buyers find suitable choices, they are often biased by the potential for a raise, higher commissions, or a free trip associated with sales of particular items. Thus, salespeople will generally not inform a customer that her best choice is something that the seller does not carry, unless the seller has no suitable alternative. One would expect that consumers would prefer to pay market niche experts directly for unbiased advice rather than paying indirectly for biased salespeople. Yet for lower-and moderately-priced items, administrative costs make this impractical.

In the real estate market, most home buyers have accepted the pervasive myth that using a broker costs them nothing.<sup>9</sup> This reduces their incentive to negotiate over fees. Yet the fees paid to the buyer’s broker are actually an avoidable cost.

Against this background, one would expect home buyers to choose to pay a broker directly for unbiased advice. Until the 1990s, however, buyers were generally content to work with agents paid by—and recognized by the law as subagents of—the listing agent’s firm. As subagents of the seller, agents working with buyers were duty-bound to pass on to sellers’ agents any secrets buyers shared with them about how high they would bid. In fact the 1983 FTC report found that more than 70 percent of buyers *and sellers* believed that the agent aiding the buyer was representing the buyer’s interests and thus some courts interpreted the common law of agency to that effect. Yet when litigation led listing brokers to be held liable for the services of buyer brokers,<sup>10</sup> the industry quickly shifted to require agents to disclose who their primary client was (although such disclosures are surprisingly neglected today<sup>11</sup>). The concept of “buyer’s brokers,” which Bill Broadbent had introduced in the late 1970s, quickly gained attention, and it appears that today about 63 percent of buyers use some variety of agents who commit to work for buyers.

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<sup>9</sup> NAR Standard of Practice 12-2 permits realtors to represent their services as “free” or without cost if the potential for pay from another source is disclosed.

<sup>10</sup> Dismuke (1993); Bokusky (1993).

<sup>11</sup> Harney (2006) reports that less than one third of buyers in 2005 were told by their agents at their first meeting who the agent represented.

Moreover, most buyer brokers—exclusive or not—appear to prefer to rely on the fees offered by listing brokers, rather than to raise the topic directly with buyers. Prohibitions against rebates also hinder the growth of flat or hourly fees in the dozen or so states that prohibit rebates. Finally, buyer brokers may fear that uncooperative traditional brokers will hinder their clients desire to amortize their broker fee by rolling it into the mortgage.

The practice of remunerating the buyer's broker from seller's proceeds can harm consumers in three ways.

## 1. Agents May Fail to Show Buyers Some Attractive Options

Leaving the payment of buyer brokers to sellers or their brokers can lead agents with buyers to withhold options from buyers, despite fiduciary duties, if 1) the co-op fee offered to the buyer's broker for a home is too low, 2) the seller appears to expect free assistance from the buyer's broker, or 3) the agent wants to discourage price competition.

Most home buyers appear unaware that, like most salespeople, agents aiding buyers are apt to make a greater effort to sell those listings that offer them the highest fee. Recognizing this, many discount brokers representing sellers offer to pay buyer brokers the going rate in the market, limiting discounting to reductions in their own share of the commission.

Buyers could attempt to correct for the pressures leading agents to fail to show them attractive options by offering to make up the difference between the fee a seller offered and the going rate; yet most buyers appear unaware of the current fee mechanism. While agents working with buyers could raise the issue, most appear reluctant to impose on buyers by requiring them to sign an agreement guaranteeing the broker a minimum fee upon a purchase. In addition, arranging to amortize such payments currently adds a complication.<sup>12</sup>

Even if buyers' brokers are offered fees at the going rate, agents may also avoid showing buyers homes out of fear that the seller will require the agent to handle all the tasks ordinarily done by the seller's agent because the seller is not using a full service broker. Agents could demand to be paid for any extra work for sellers, but most prefer to avoid the current awkwardness of such requests. Traditional agents may also avoid homes represented by entities that threaten the stability of the traditional system (favoring cooperation over price competition). Thus, traditional agents willing to offer rebates to customers (only from the broker's own share of the commission) feel pressure to act secretly out of fear of being shunned by their colleagues, if not fired by their broker! Although such practices resemble a quasi-boycott, the lack of an explicit agreement has allowed them to avoid antitrust prosecutions.<sup>13</sup>

A 2005 *Wall Street Journal* editorial (2005a) complains that such practices represent "a clear breach of the fiduciary duty of the agent to find the best home at the lowest price for clients." Not only do the practices violate duties imposed by state laws of agency, but they conflict with the first principle of loyalty in the National Association of

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<sup>12</sup> If a buyer has agreed to pay a specific fee to the buyer's agent then the seller should be willing to add that fee to the price of the house and agree to pay it to the buyer's broker, and thus allow it to be amortized in the mortgage, but some sellers and their agents might resist this.

<sup>13</sup> Although group boycotts are violations of section 1 of the Sherman Act, *N.W. Wholesale Stationers, Inc.* (1985); *Fashion Originators' Guild of Am.* (1941), ruled that mere conscious parallel conduct alone, is not enough, although inferences about group understandings may be drawn.

Realtors® (NAR's) "stringent, enforceable" code of ethics.<sup>14</sup> Yet, the *Wall Street Journal* (2005a) observes: "To our knowledge, neither the National Association of Realtors nor the state real estate commissions have ever sanctioned a real estate agent for this breach of ethics."<sup>15</sup>

## 2. Reducing Buyers' Incentive to Negotiate

By encouraging buyers to believe that it costs them nothing to use a broker, the current fee arrangement deters most buyers from negotiating over their agent's broker's fee. Hence, there is little pressure to reduce the fee paid to buyer brokers from half of the "going rate," e.g., half of six percent. Thus, most MLS listings offer buyers' brokers half the standard commission charged. The situation is changing, however, due to the emergence of referral firms, like LendingTree and an increasing number of brokers who offer buyers a rebate from the commission paid by listing brokers. As buyers discover that even "full service" buyer brokers are willing to rebate a portion of their commission, more are likely to demand lower fees.<sup>16</sup>

## 3. Unnecessary Fees Allocated to Pay Buyer Brokers

When listing brokers are asked to defend their commission requests, most explain that they "must" offer buyer's brokers a co-op commission at the "going rate," e.g., three percent or brokers will not bring buyers to see their home. Yet even those who acknowledge that the buyer may have no broker, generally only offer to reduce the total commission by one percent of the three they "needed" to offer. Certainly if sellers want the listing agent to handle tasks for which agent aiding the buyer is generally responsible then the listing broker is certainly entitled to some extra pay, but not when the buyer has already hired an attorney or consultant to handle tasks for buyers.

Those who buy homes without a broker's help usually ask sellers to reduce the sale price by the amount that would have been paid to the buyer's broker. Sellers may desire to comply, but listing agreements usually give the listing broker the right to keep the full fee.<sup>17</sup>

## IV. Refusing Reductions to the Bundled Price for Those Desiring Much Less Service

There are many reasons why sellers may require buyers to purchase products as part of a bundle rather than offering them on a stand alone basis at reasonable prices. Sellers with market power may use bundling to capture a greater share of the surplus

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<sup>14</sup> Ayt (2006) observing that the National Association of Realtor Code of Ethics and Standards of Practice requires its members to put their clients' interests ahead of their own interests.

<sup>15</sup> This may, however, be due to a state's failure to authorize prosecutions of such anticompetitive actions.

<sup>16</sup> Pressure may also mount if more sellers list their homes with firms like Foxtons and Catalist (which offer brokers for buyers only 1.0 and 1.5 percent commissions, respectively).

<sup>17</sup> Listing brokers may actually expect to work for three percent most of the time (where buyers have agents), but with the expectation that they will keep all six percent (or at least five) about 20 percent of the time.

value created by an item or use it to increase the entry barriers to the industry.<sup>18</sup> Sellers without market power may also have good reason to set a single price for a bundle and refuse to give discounts for subsets of the bundled items. First, it might be cheaper to produce only one popular bundle of basic features. Second, the bundle might represent a “loss leader” created primarily as a marketing device. Third, a service provider’s professional preference may be to handle only whole tasks.

None of these latter three conditions appear to apply directly to the real estate brokerage market. Services offered appear relatively distinct and the costs of each appear to be easily avoidable, which is why at least some buyer and seller brokers are offering them à la carte. Meanwhile, most agents expect to cooperate with another agent on a purchase.

Nevertheless, traditional brokers, contending that the public expects an “agent” to provide some minimum set of services, such as delivering offers, have successfully helped to pass laws in at least 17 states that require brokers to provide some minimum set of services. Yet this prevents a seller from paying solely to engage a broker to place a listing on the local MLS, just as they now pay a newspaper for placing a classified ad and nothing more. If policy makers were truly concerned that consumers might be denied a service they expected, an effective disclosure and/or a waiver option would be the appropriate response to this, as noted by the DOJ, the FTC (1983), and the *Wall Street Journal* (2005b), among others, but only about five of the 17 states now permit sellers to waive state minimum service requirements. If the laws were really intended to ensure that consumers received all the services that they expected, they would explicitly require listing brokers to support the widest dissemination of the seller’s listing, and brokers engaged to show buyers homes to disclose all the homes meeting the buyer’s search criteria. These are services that consumers are now often being denied, without their knowledge, and to their detriment!

The practice of unnecessarily bundling services has three potential harmful effects on consumers:

## **1. Bundling Denies Consumers the Option of Lower Fees for Limited Service**

Although some home buyers and sellers want the entire bundle of services offered by traditional brokers, many others desire to save money by handling many tasks themselves, even if the lack of unbundled services leads about 20 percent to go completely FSBO or to purchase without a broker. Even though such customers generally require substantially less time and effort from agents, the current standard rate structure used by traditional brokers demands that consumers choose all or nothing. Those expecting to pay \$600,000 for a home will also expect to pay about \$18,000 (half of six percent) to a buyer’s broker even if they only want 10 hours worth of assistance with paperwork and routine closing tasks. The situation is similar to that which occurred in the funeral industry in the 1970s, where “industry practice was to quote a package price based on a multiple of the cost of the casket, stating that ‘this includes our full range of services’” (Mitford 1998).

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<sup>18</sup> Such practices may enable the seller to distort competitive marketplaces and decrease the opportunity for others to compete in its monopoly market, leading the courts to look unfavorably on such bundling or tying.

Traditional brokers claim that the small market share of “fee for service” or à la carte services<sup>19</sup> (which they claim are now widely available), indicates little consumer demand, but that result appears to be largely due to the anticompetitive, if not illegal, tactics of traditional brokers. The primary problem in this area for sellers has historically been their inability to place their listings in the relevant local MLS. Although there are now brokers in most local markets willing to place listings on their local MLSs for a nominal fee, the traditional brokers are now resisting non-traditional competition by failing to inform their buyer clients about listings handled by non-traditional brokers. Some MLSs refused to pass listings on to realtor.com if they did not include the “exclusive right to sell” agreements used by traditional brokers, although the FTC cracked down on this practice in summer 2006 (FTC 2006). Still, as long as traditional brokers dominate local markets and provide inferior cooperation to non-traditional brokers, buyers and sellers who want to avoid being discriminated against by the dominant “old boys club” and the resulting harms<sup>20</sup> will feel compelled to forsake the fee-for-service options offered by non-traditional brokers.<sup>21</sup>

## 2. Bundling Aids Brokers’ Selfish Efforts to Constrain Seller Marketing

Sellers generally desire to reach as many bona fide potential buyers as possible, using all cost-effective media, including websites. Under the standard price structure, however, sellers who desire an “association with a traditional broker” must sign a contract that grants their listing broker full control over their “listing,” (DOJ/FTC 2005) and some traditional brokers contend that this gives them “ownership” of the listing. This leads many traditional brokers to compromise the interests of sellers by limiting the dissemination of listings, so as to enhance the listing’s value as bait for attracting new buyer clients. Listing brokers want buyers to come to a website affiliated with their firm to see listings so that their firm will have the best chance to gain those buyers as clients even if they do not buy the particular listing that attracts them. If other entities post the same listings on their competing websites, buyers may make first contact with the listing firm’s competitors and be more inclined to employ one of them for aiding their home search. In the same vein, brokers frequently withhold a listing from other brokers until their agents have had the chance to expose it to their own buyer clients (“pocketing” a listing), so that they might collect both halves of the commission (“double-ending”),<sup>22</sup> even though such “in house” sales often deny sellers the chance to benefit from higher bids that might be offered by buyers represented by other brokers.

In May 2003, the NAR adopted a policy that listing brokers be permitted to restrict the online republication of their listings by competing brokers, and in September 2005 the DOJ brought suit against the NAR for its most recent version of the policy (U.S. v. NAR). The DOJ pointed out that the chairman of the NAR’s working group on the

“Brokers should consider how technological change affected the airline reservation business.”

<sup>19</sup> The market share of non-traditional brokers appears to be about 10 to 17 percent.

<sup>20</sup> It appears that the only empirical data on this issue found that non-traditional brokers closed on less than 60 percent of their listings while traditional agents closed on about 88 percent.

<sup>21</sup> Consumers may feel constrained until alternative brokers reach a tipping point, such as when a local FSBO database includes 30 percent of the homes for sale in a community.

<sup>22</sup> Most MLSs, however, require members to submit their listings within 72 hours or some such period.

rules admitted that refusing to share a listing with others “‘may not be in the seller[']s best interest,’” and that “he took comfort in the fact that the rule did not require brokers to disclose to clients that their listings would be withheld from some prospective purchasers . . .” Independently, a California court also refused an MLS’s request to issue an injunction to prevent a rival from publishing data included in its listing.

The industry offers three defenses of its policy. First, it notes that MLSs were established and remain as a business-to-business resource for brokers to share information cooperatively among themselves, not as a retail service for buyers and sellers. While this is historically accurate, it does not justify denying sellers the chance to make their listings directly available to all home shoppers now that this is technologically practical, especially since a large number of buyers do not use brokers. Brokers should consider how technological change affected the airline reservation business. Airlines happily offer consumers the chance to discover ticket availability and make a direct purchase without the involvement of a travel agent. The airline-created Orbitz provides this. If the dominant airline reservation systems had been owned by traditional travel agents, however, they might well have acted like traditional real estate brokers, limiting consumer access to airline listings, forcing buyers to work with an agent, at least to make a reservation. Intermediaries who refuse to serve buyers’ and sellers’ best interests by offering them the access they desire, seriously risk being displaced by a new entrant that will.

Some listing brokers also claim that they deserve the same rights as retailers like Neiman-Marcus: to enjoy the ancillary benefits of the traffic that “their” inventory attracts. This position is somewhat analogous to the one taken by online auction site eBay when “aggregator” firms, like Bidder’s Edge sought to attract buyers by offering a single aggregated list of all of the offerings in a product category (available from many, if not all, auction sites), including eBay (2000). eBay sued the aggregators to prevent them from using eBay’s listings to attract shoppers interested in those listings to their sites rather than to eBay. Although eBay won a court victory, the court’s holding focused on its concern that aggregators could cause harmful congestion to eBay’s computers, a concern that would not apply to MLS listings. If buyers want one-stop access to an aggregated and easily searchable set of available homes of all kinds, then brokers should compete to offer that. Home sellers do not grant brokers exclusive rights to their listing in order to allow them to affirmatively limit its dissemination to potential bona fide buyers.

Finally, some industry supporters argue that since brokers compose the listings, republication of listings is a violation of the broker’s copyright. Setting aside the fact that copyright law does not protect facts about a listing *per se*, there is the more fundamental matter that brokers’ fiduciary duty to sellers certainly prohibits them compromising their clients’ interests like this.

Listing brokers also injure the interests of sellers when they offer non-traditional brokers only “adverse splits,” i.e., less than a 50-50 split or even nothing at all or refuse to show homes to clients of non-traditional brokers. Again, their fiduciary duties should not permit such tactics.

### 3. Bundling Inhibits Price Competition on Individual Selling Services

Both selling and buying a home involve many relatively separate and distinct tasks and different agents will perform some better than others. Those best at negotiating when more than two parties are participating, might be below average in “staging” (decorating a home to sell well) or vice versa. The traditional rate structure, however, deters the emergence of specialized providers of these distinct services—who might well be able to provide a clearly superior level of service for that task at a lower, competitive price—by requiring sellers to purchase the full bundle of services offered by traditional brokers.

Many expected the Internet to drastically change the situation. By permitting home sellers to post a detailed description, including photos, of their home on a website easily available to home buyers, the Internet triggered predictions that the level of FSBOs would rise dramatically to as much as 40 percent of all homes sold.<sup>23</sup> In an effort to offer brokers an option for earning income from FSBOs rather than losing their business altogether, Julie Garton-Good, a highly respected real estate educator/broker, wrote a book proposing that real estate agents transition into consultants, offering à la carte services for reasonable fees Garton-Good (2001). By early 2006, however, the NAR’s fear of a great rise of FSBOs appeared to disappear.<sup>24</sup> Recently, traditional brokers have sought to protect their business model by raising entry barriers through the adoption of the minimum service requirements discussed above. Those rules force brokers willing to place a listing in the MLS for a flat fee to either offer all of the required services—and raise their prices accordingly—or go out of business.

## V. Uniformity of Rates Irrespective of Expertise of Provider or Difficulty of Specific Task

In most markets buyers have options ranging from higher-priced, higher quality to lower cost, lower quality. Prices also generally reflect the estimated difficulty of performing a task. In some cases, however, retailers or service providers choose to set a single price for all options offered. The additional revenues from charging more for some options might be offset by the administrative costs of a more complicated pricing mechanism. Hence, many cafeteria-style food “bars” charge a single price per pound for all choices and low-priced hair cutters generally do not charge more for best workers or less to those, like the author, with few hairs to cut. Uniform prices may also emerge for services that are sufficiently routine that excellent quality can be provided with relatively little experience. This category may include the preparation of 1) uncontested divorces for childless couples with no significant assets or 2) federal income tax returns for single filers with solely payroll income, no dependents, and nothing else unusual.

Given the size of the fees paid to brokers, it would seem just as practical to price each broker’s services or the price of a project based on the brokers’ skill level and experience or the perceived difficulty of the task as it is for lawyers and accountants

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<sup>23</sup> Gomez Research predicted that, aided by the Internet, over 40 percent of homes would be sold FSBO (Willis 2003).

<sup>24</sup> The NAR now reports that FSBO rates recently peaked at 18 percent in 1997, before stabilizing at 13-14 percent.

to do so. Rates appear to vary based on a task's difficulty in Sweden, Finland, Ireland, Mexico, and Belarus, and in the 1970s at least some brokers set their fees based on how long the sale took. Although levels vary among regions and somewhat from cold to hot markets, "the shrewd, entrepreneurial, risk-taking broker willing to base commissions directly on his or her own estimate of the difficulty of selling a particular property appears to be absent from all geographic markets" (FTC 1983).

Given the incremental financial and other value that superior agents can provide, one would expect superior negotiators and those with exceptionally detailed knowledge about a community to charge two, three, or more times more than novices. Nevertheless, U.S. residential brokerage firms do not advertise different rates for different agents based on their expertise the way other professional firms do. This suggests that brokers are pricing their best agents too low or, more likely, their novice agents too high, to discourage price competition.

Uniform rates hinder buyers' chances to secure superior or lower-price services by offering to pay more or less than the standard fee. The fee framework encourages the most capable agents to seek those clients desiring higher-priced properties, even where the clients have no need for the agents' special skills. After all, assisting a family seeking a multi-million dollar home, but requiring little assistance could pay an implicit fee of even \$10,000 per hour.<sup>25</sup> While there is normally nothing wrong with the highest bidder getting the services of the best agent,<sup>26</sup> here a family willing to pay \$600 per hour for an agent with special expertise about schools for children with special needs, may, if they are seeking a home priced at the median of the community, lose out to a buyer with no desire or intention to outbid them. A similar problem would arise if the legal fees for a divorce were based on the size of a couple's joint estate rather than on the quantity or complexity of the legal services desired.

## VI. Prohibition Against Rebates

Although policymakers try to prohibit rebates that represent hidden kickbacks, which disguise conflicts of interest, agreements not to offer discounts are ordinarily *per se* violations of antitrust law. Most of the state anti-rebate laws concerning broker fees<sup>27</sup> appear to have been designed to prohibit socially harmful payments. Rebates by brokers, however, permit socially desirable price competition over broker fees. Prohibiting them denies home buyers a chance to obtain a lower broker fee, merely to protect the revenues of traditional brokers, who support it.<sup>28</sup>

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<sup>25</sup> If the agent described in Hagerty (2005) seeking half of the \$620,000 commission for aiding the buyer in finding the \$15.5 million property is successful and that broker spent only 30 hours helping the buyer choose the home (though no time for closing, etc.)

<sup>26</sup> In fact Miller (2005) has found that most top agents work about 50-70 hours per week and tend to specialize in listings rather than selling.

<sup>27</sup> Three states expressly prohibit rebates, Alabama, Kansas and Mississippi. Six or seven others base their prohibitions against rebates on laws prohibiting the sharing of real estate commissions with anyone but a licensed agent. These include Alaska, Louisiana, New Jersey, North Dakota, Oklahoma, Oregon and Tennessee. Missouri bases it on a statute prohibiting inducements. Finally, Iowa prohibits rebates when the consumer uses two different brokers.

<sup>28</sup> Although the NAR takes no official position on anti-rebate laws, the laws appear to result from NAR state affiliates, and the NAR's general counsel published an April 22, 2005 memo that observes that even anti-competitive state laws are generally exempt from the federal antitrust laws.

Firms that offer such rebates aid buyers who do not realize that they can obtain reduced fees from their “free” brokers. These firms include retailers like Costco, which secure “affiliate” discounts for their members, and “lead generation” entities, like LendingTree and HomeGain, which negotiate a “referral fee” of as much as 45 percent of the buyer agent’s broker’s fee and then seek to attract buyers by offering them a share of that referral fee as a rebate. An increasing number of brokers are also voluntarily offering rebates of a portion of the commission that listing brokers pay them, particularly when asked to match a competitor.

Meanwhile, a number of firms are offering substantially larger rebates based on business models that substantially reduce their costs of serving buyers. Seattle-based Redfin, Chicago-based BuySide Realty, and Mid-Atlantic-based IHS Realty, all offer buyers rebates of about 67% or more of the commissions they receive from listing brokers, where not illegal. Although they do leave it to buyers to drive themselves around to identify the home they want to purchase.<sup>29</sup> Buyer brokers who set flat fees or hourly rates agree to rebate any additional amount paid by the seller.

## VII. Four Questions that Should Stimulate Price Competition

The obstacles inhibiting the availability of non-traditional pricing structures could be overcome, for the most part, if home buyers and sellers received answers from agents to four short questions before hiring them. Before reviewing these questions, it is important to consider how to ensure that consumers receive suitable responses. Even if the political clout of traditional brokers could be overcome to mandate additional, legally-required disclosures, brokers would likely simply add a few more clauses to the long, legalistic disclosure statements that already overwhelm the consumers. A better option would be a combination of efforts by consumer advocates, including *Consumer Reports*, media consumer reporters, and enlightened government agencies, like the DOJ and FTC, to use a few, short, sound-bite sized messages to prompt consumers to ask the questions themselves. It would also help if state departments of consumer protection and attorneys general made a greater effort to investigate and prosecute cases where agents working with buyers clearly violated their fiduciary duties to clients.

“If most buyers became aware of such current broker practices, traditional agents might feel compelled to alter their policies and routinely inform buyers of all relevant options, i.e., provide full service.”

### A. Buyers Should Ask: Might You Fail to Show Me a Home Ideal for Me Due to the Seller’s Choice of Broker or the Fee Offered to You?

Although, most buyers relying on traditional agents assume that their agent is scouring the entire market and showing them all homes that meet their search criteria, regardless of what fee is offered to the broker or which broker a seller is using, many buyer brokers fail to show the buyer some homes they would want to see (as discussed above). Such buyers deserve to learn this before hiring the broker so they can seek truly “full service” from a broker loyal to them, possibly an exclusive buyer’s broker.

<sup>29</sup> Redfin, however, offers to show buyer homes for an extra charge, and also sets a minimum fee of \$2,000. <http://www.redfin.com>. ZipRealty, one of the first in this niche, in California, offers a 20 percent rebate of its share of any commission it receives while providing full service.

If most buyers became aware of such current broker practices, traditional agents might feel compelled to alter their policies and routinely inform buyers of all relevant options, i.e., provide full service. This would make it easier for non-traditional brokers with different rate structures to represent sellers more successfully and make them more attractive to sellers. Alternatively, if buyer brokers explicitly lied to buyers about their practices, it should make it that much easier for state consumer protection officials to prosecute them for clear violations of their fiduciary duty. It would also be likely to dramatically increase buyer demand for the independently operated MLSs—directly assessable by buyers—discussed above.

### **B. Buyers Should Ask: What Dollar Amount Do You Expect to be Paid for Helping Me Buy and Close on a Home and for How Many Hours of Work?**

As observed above, many home buyers believe that the agents working with them cost them nothing. Accordingly, they have no reason to consider hiring a broker willing to charge them a flat fee or an hourly rate that would often be less than what a traditional broker would cost. To enable such non-traditional brokers to compete effectively, buyers should ask the dollar amount their broker is likely to receive and an estimate of the total hours of service they are likely to require (on average given market conditions). This data should encourage buyers preferring to handle some of the tasks themselves to discuss a lower fee or an hourly rate with brokers.

### **C. Sellers Should Ask: Can I Direct Some or All of the Fee Offered to a Buyer's Agent to the Buyer Instead, if the Buyer Has Made Alternative Arrangements?**

As discussed above, even many lower-priced discount brokers tell sellers that they must offer co-op fees at the prevailing rate, typically three percent if they want to attract buyer brokers. Yet about 20 percent of the time, buyers may choose to act without a broker and demand a three percent price discount to reflect the avoided cost of a buyer's broker. Other buyers may insist on discounts where their brokers are willing to charge less than the co-op fee offered by the listing, but their states ban rebates. Meanwhile, where listing brokers have indicated that they will pay lower commissions or none at all to some brokers, buyers represented by such brokers may demand a price reduction to permit them to finance the full fee they agree to pay their broker themselves.

Unless the listing contract gives the seller such options, the listing broker might refuse to reduce the typical commission in these cases or only agree to pass on a portion of the costs avoided to the seller. To be fair to listing brokers, the listing agreement should provide such brokers with a reasonable additional amount if the buyer has not made his or her own arrangements to handle all of the tasks that are normally handled by the buyer's broker, if the listing broker will be expected to handle them. Otherwise the seller should be free to pass on any costs the buyer can avoid to the buyer.

## D. Sellers Should Ask: Will They Limit Dissemination of Listing Information?

As discussed above, most sellers desire and expect their brokers to seek maximum exposure for their home by encouraging their listing to be spread far and wide as part of full service. Accordingly, as part of a general disclosure of what specific services they will receive, sellers deserve a “listing exposure disclosure:”<sup>30</sup> to know if their broker intends to prevent competing brokers from displaying information about the seller’s home so sellers can avoid such brokers.

## VIII. Conclusion

The traditional, straight percentage-of-sale-price residential real estate brokerage commission does not serve the interests of either home buyers or sellers. Fees are unrelated to the quantity or quality of service provided by brokers and their agents. The rate structure creates little incentive for agents to provide the value-added services of which many are capable, and also produces some serious harms to buyers and sellers. The traditional commission rate structure has become structurally unsound and should be rebuilt.

The foundation of a new fee structure should have buyers’ brokers setting their own fees or negotiating with buyers; not relying on standard, default commissions set by sellers’ brokers in the MLS. The traditional practice of sellers’ brokers specifying the fees that buyers’ brokers charge to the latter’s own clients, should be recognized by appropriate governmental bodies as at least an attempt to fix market prices. Antitrust laws should be interpreted to prohibit one firm from attempting to set the price that its competitors charge for a competing service.

The situation today is very different from what it was prior to the the 1980s, when sellers’ brokers noted their co-op fee offer in their MLS listing because they were making an offer to the agents working with buyers to join the seller’s broker in serving the interests of the seller. There was nothing anticompetitive about posting an offer seeking to engage a subagent. Today, however, most buyer brokers commit to serve buyers’ interests, and their fiduciary duty is to buyers. There is no longer any reason to permit listing brokers to set the default prices that these competing buyers’ brokers charge to serve their own customers.

The NAR claims that the elimination of interbroker compensation would destroy the MLS, but that is plain wrong. The NAR’s real fear about this approach is that the elimination of interbroker compensation would diminish the ability of traditional brokers to frustrate vigorous price competition, and thus likely lead to a dramatic fall in broker revenues.

Therefore, policymakers eager to aid consumers and foster economic efficiency through competition should support this separation of fee setting. It would also eliminate the harm now caused to competition by state anti-rebate laws and disputes over which broker was entitled to the buyer broker fee as the “procuring cause” of the buyer’s offer. Policymakers should also act to ensure that consumers have the same chance to

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<sup>30</sup> This phrase was offered by Bill Wendel.

amortize their broker costs as part of their mortgages, whether or not the seller agrees to include that fee in the sale price of the home.

Brokers should remain free to set their fees as percentage commissions, but for routine brokerage tasks, effective competition would almost certainly lead consumers to prefer brokers who set flat fees, hourly rates, or some combination of the two. Consumers will probably continue to prefer brokerage agreements that defer any payment until the relevant transaction was completed, but broker contracts should allow brokers to receive some reasonable minimum level of compensation in the event that the client terminates the relationship.

Percentage-based fees should not disappear, but they should be used solely to motivate real estate agents to generate incremental value. Sellers should offer their brokers' agents (alone, without any splits with others) a substantial share, e.g., 20 to 50 percent, of any increase the agent can secure in the selling price above some agreed upon benchmark. In volatile markets, however, benchmarks should include variable elements pegged to the most recent sales of comparables or inventory levels. Buyers, meanwhile, once they selected a home, should offer their brokers' agents a substantial share of any price reduction the agent is able to secure. Both buyers and sellers might also offer bonuses for quick results to agents who met designated deadlines.

Reaching this result will be difficult, given that these reforms could cost traditional brokers \$30 billion in annual revenues. Still, pressure from declining home prices could be a catalyst for change. Superior agents should also recognize that the new environment would lead to a mass exodus of the least qualified agents. This would enable them to increase their billable time and spend less time prospecting for clients. In fact, one might expect that the best agents would earn higher incomes, while consumers would receive higher quality service at lower prices. Yet given the \$30 billion at stake, NAR's state affiliates are likely to be able to continue to pressure state legislatures to protect the traditional system. Consumer success will require effective work by consumer advocates. The consumer media and housing counseling agencies must prompt consumers to ask agents/brokers the four questions proposed in this article, which should ensure that they pay only competitive prices for only the valuable real estate brokerage services they need or desire.

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