

Chapter 3 Material

The two problems from Chapter 3 are discussed. In Appendix 3 following, the classic models of oligopoly are solved and then discussed relative to ideas from this chapter.

3.1 I originally wrote this answer in 1990, when the 6% commission was very largely adhered to in the industry, at least in California. Now, in 2015, there is a definite trend in the direction of undercutting this “standard.” I think the answer that best connects this case to the chapter is one where you begin with the “picture” as of 1990, and then see what has happened. So, to begin, here is what I wrote in 1990:

The 6% commission is maintained by implicit collusion among brokers. If one broker charges a smaller commission, other brokers fail to cooperate with the deviator. In real estate sales, cooperation among brokers is essential to each; brokers rely on each other for information about available houses or prospective purchasers. If brokers as a group wish to punish a deviator, they can do so actively by failing to arrive for appointments or by providing nonserious buyers or sellers for the clients of the deviator, they could advise their own clients to make low offers or high asks when dealing with the clients of the deviators or simply fail to share information in a timely fashion with the deviator. All these things substantially punish the deviator. So, if deviations from the 6% commission “standard” can be detected, it is not hard to see how collusion could be sustained.

This collusive scheme is vulnerable in three ways: (1) Entrants into the business could increase competition and make collusion harder to sustain. (2) Home owners and potential buyers can try to sell and buy without the services of a broker. (3) The scheme requires that brokers be able to observe the actions of other brokers, so that deviations from the 6% rule can be observed. Brokers control entrants into their business by their control of the licensing of new brokers; they control the substitution of direct sales or purchases by their monopoly on information about available homes and prospective buyers; and they maintain observability by their collection and dissemination of the terms of sale, including commissions and other fees, on a transaction-by-transaction basis.

Therefore, to break the cartel, I would advise the state legislator to take three actions:

1. Remove the licensing function from the Board of Realtors. Put it under the control of a state agency, instead. I am not very strong on this recommendation, because there is every possibility that the state agency will be “captured” and controlled by the cartel; it will then have greater coercive powers by virtue of being an agency of the government. But, in conjunction with my other two recommendations, this recommendation may have some impact.
2. Mandate that multiple listings be made available to the public on an at-cost basis and carry information about no-agent houses for sale. That is, any individual who wishes to sell a house may submit a listing to the multiple listings, for a nominal fee, which would be designated as a listing by a private buyer, who would not cooperate with agents or pay any commission. And a private individual who wishes to obtain the multiple listings book must be allowed to purchase it at cost.
3. Do not allow the collection or dissemination of information on fees by the Board of Realtors on a case-by-case basis. When local boards complain that this denies information to consumers, allow the collection and dissemination of anonymous grouped data; that is, report means and perhaps standard deviations of commissions and fees on both an absolute and percentage basis.

The first two actions should generate pressure on brokers to lower commissions; the third should remove the possibility of punishment of those who deviate from the cartel, effectively breaking the cartel. If forced to pick only one of the three, I would choose the third as the most important.

Note that the state legislator is likely going to commit political suicide with this campaign. Realtors are very easily and well organized, while the house buying and selling public is dispersed. If this legislator runs for office again, she can expect her opponent to get lots of contributions from real estate agents.

Now roll the clock forward to 2015. Studies by the Anti-trust Division of the U.S. Department of Justice come up with average commissions of 5% to 5.5%. A 2008 study by the Department of Housing and Urban Development indicated that agent fees on FHA Mortgages are “well characterized as \$970 plus 4.5% of the house value.”¹ If you visit websites that discuss this issue,

¹ See http://www.huduser.org/Publications/pdf/FHA_closing_cost.pdf

you'll see a lot of posted responses, probably from realty agents, claiming "you get what you pay for," which is a clear indication that the cartel is showing some cracks.

Why? I think there are (at least) two factors at work. First, there are sub-communities (often ethnically based) of realtors who are willing to work with one another and undercut the rates charged by the main body of realtors. The folk theorem is about why one player will not deviate; coalitions of a large number of players can often deviate profitably, since the threat point of pushing deviators to their max-min becomes less onerous. And, second, the internet provides enormous amounts of "free" information to buyers, information that detracts from the power of the realtor cartel, whose power was based on their (previous) monopoly in information.

3.2 The principle on which the EEC was founded was free trade within the community, and a uniform stance by the community on how member states would trade with the rest of the world. When the U.K. applied (along with Denmark and Ireland) to join the original six (Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany), the U.K. asked that it be allowed special trading rights with its Commonwealth nations. The six and, in particular, France, pushed back, saying (essentially) "if you want to join our club, you play by the club rules."

In theory, the U.K. could have been granted special trading privileges: The folk theorem says that lots of things can be equilibria.² But if the U.K. gets special treatment, why wouldn't the other member states? Simplicity and clarity of a deal are important to the deal being kept, and the original six were not willing to open up "special status" arrangements for the U.K., in fear of what this would mean in the future.

(Added in 2018: Of course, Brexit has significantly scrambled the simple story told above. The United Kingdom has, more or less, sought the sort

² I appeal to the folk theorem because these are sovereign states: Treaties that they sign are only enforced as long as the individual states see it in their interests to adhere to the treaties (added in 2016: although to remove itself from the treaty may mean a wholesale "renegotiation" of relations with the other parties to the treaty; cf. Brexit). Ultimately, a member of the EEC obeyed the rules out of "fear" of what the other members would do to it if it violates the rules. That was certainly true in the early 1970s, when the U.K. joined, and it is true today: As I write this answer in 2015, we are watching how the sovereignty of Greece means that agreements between Greece and the institutions of the EU are only as good as the future interests of the parties allows. (And added in December 2016: And now we have a "sovereign state," Great Britain, that wishes to exit, with negotiation over the terms of that exit ongoing. Great Britain—or perhaps it would be more accurate to say, England—wants access to the common market without open borders for workers or other pieces of the "deal." Time will tell what they get.)

of relationship that Norway, Iceland, and Lichtenstein have, though the European Economic Area Agreement. But, as I write this paragraph, the EC has taken a hard line and said no. And, as I write this paragraph, a major issue is trade between Ireland, inside the EC, and the United Kingdom, most notably between Ireland and Northern Ireland. As things settle, I'll probably be revising this paragraph.)