

# Perverse incentives and the myth of the estate agent commission

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Getting human beings to perform a particular action isn't as straight-forward as offering them the carrot if they do and the stick if they don't. This is because, contrary to popular belief, there isn't always a direct, linear relationship between human behaviour and reward.



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Depending on the situation, it may be to the individual's benefit to choose pain over pleasure.

There are few places where this is as clear and well documented as in the real estate industry, where most business models offer agents, as their reward, a cut of the selling price of the property.

The theory goes that this model motivates agents to ensure not only that a sale takes place but that it is also at the maximum price. After all, a sale at the maximum price means more money in the estate agent's pocket upon conclusion of the deal.

Some models even go so far as to pay agents only on a commission basis – the ultimate incentive for them to go for the maximum possible price, right?

Actually, no.

## Calculations based on individual circumstances

The reality is that estate agents working for commissions make a series of complex calculations based on their individual circumstances. These can lead to agents, who are otherwise generally good people, offering sellers advice that isn't in their best interests.

Take, for example, the commission-only agent who hasn't made a sale in a long time. Her savings are running low and she has to make a sale soon or face defaulting on debt repayments. This creates a powerful motivation for her to advise sellers to take the first reasonable offer that comes along – even when she knows that it is likely that higher offers will come if the seller were to wait; even though her commission in rand terms will be lower if the seller takes the first offer.

For her, a lower commission today is better than a higher commission in two weeks if it means avoiding defaulting on debt in the meantime. The commission in this instance works as a perverse incentive – an incentive that has unforeseen negative or undesirable outcomes.

Of course, we haven't always known about the effects of perverse incentives in the real estate industry. It took Steven Levitt's 2009 hit book *Freakonomics* to call mainstream attention to it. And even then, the responses were that there is little that can be done. Estate agents do provide a necessary and valuable service – and commissions in some circumstances do motivate them to represent the interests of the seller.

But why should sellers settle for the best in *some* circumstances when it is possible to help and empower agents to *always* represent the interests of sellers?

## Fixation on sales volumes

The answer is that traditional estate agent franchises and the franchise owners, who are best positioned to change the model, also benefit from it – the former usually taking a 45% cut of the estate agent's commission and the latter a 10% cut. Weighed down by the overheads of running a network of branches, they are fixated on generating enough sales volumes to cover costs and bonuses rather than what is in the interests of the seller.

It's not easy to change this model, but it is entirely possible. For example, paying agents a salary (with bonuses for quality of service based on client feedback), and charging sellers a fixed-fee commission enables the agent to focus on what's important - selling houses and providing great service at every step of the process.

Modern technology facilitates this by making it possible to automate many of the time-consuming and manual processes that are still common in the industry - like agents having to call sellers to schedule viewings. This frees up the agent to focus on the seller and make sure their interests are served.

By taking the best qualified agents, with the advantages modern technology offers, it is possible to remove the perverse incentives that exist in the industry, and get better results for everyone.

## ABOUT THE AUTHOR

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