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The Residential Real Estate Brokerage Industry: What Would More Vigorous Competition Look Like?

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Executive Summary

The residential real estate brokerage industry represents a troubling instance of false appearances. Though the numbers of sales agents and brokerage firms, plus easy entry, would appear to offer the promise of vigorous competition, actual practices in the industry have caused reality to fall substantially short of the potential. After recounting the history of the transition of the securities industry from fixed and non-competitive stock brokerage commissions to far more vigorous competition, I draw on that experience to describe what vigorous competition in the residential real estate brokerage industry would look like. I also suggest public policy measures that would help bring about more vigorous competition.

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1. Introduction

The real estate brokerage industry presents a troubling instance of an industry that, on its surface looks adequately competitive. Nationally, there are currently about two million active real estate agents and brokers, associated with about 100,000 firms.[1] The relevant market is, of course, much more local -- metropolitan areas or even individual towns. Still, that national number spreads fairly thickly across the U.S.,[2] and entry is relatively easy.

Nevertheless, this author, along with many other observers of this industry, has strong suspicions that it has not been fully competitive. The historical prominence of "the 6% (or, in some communities, 7%) commission" is one troubling indicator. Another is research findings that there has been a strong tendency of actual real estate commissions to clump at exactly 6% or 7% (depending on the local area)[3] and that commission rates have been largely insensitive to large variations in house prices.[4] Yet another is the history of the industry in using the local multiple listing service (MLS) -- a valuable centralized source of residential real estate sales information -- as a vehicle for excluding "mavericks" who might bring greater price competition to the industry.[5] Still another is the industry's recent lobbying efforts -- and successes -- at the state government level to achieve regulation that restricts competition.

Consequently, it seems likely that a more competitive outcome is possible -- if permitted by the states and by the industry itself. This essay will discuss what that more competitive outcome would look like and will suggest public policy steps that would help achieve this more competitive

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[1] The Association of Real Estate Law Licensing Officials' (ARELLO) data show about 2.1 million “active” brokers and salespersons and about 360,000 additional “inactive” brokers and salespersons in the U.S. as of (approximately) the third quarter of 2005 (ARELLO 2006, p. 5). At year-end 2005 the National Association of Realtors (NAR) listed the number of members of the NAR at 1.35 million. (The term "Realtor" is a registered trademark of the NAR.) ARELLO data for 2004 show 98,000 “active” firms (ARELLO 2005, p. 5). Weicher (2005), however, reproduces data from the Census Bureau and the Bureau of Labor Statistics that would imply substantially lower employment numbers.

[2] For example, the NAR reports that there are about 1,700 local associations of Realtors.

[3] See Hsieh and Moretti (2003) and GAO (2005) for summaries of these findings.

[4] See Hsieh and Moretti (2003).

[5] The U.S. Department of Justice has a long history of suing MLSs on such grounds, of which its suit in September 2005

outcome. In so doing, I will draw heavily on the historical example of another "brokerage" industry where competition was inhibited: the stock brokerage industry prior to the early 1970s. The experience of that industry prior to the development of fully competitive stock brokerage commissions in the mid 1970s -- and the experience of that industry and its pricing structure since the mid 1970s -- will prove instructive for the real estate brokerage industry.

To anticipate that discussion: A more competitive outcome would surely mean that average fees would be lower than they are today and that "the 6% (or 7%) commission" would be unlikely to remain as the modal fee. But also a more competitive outcome would allow for a greater range and variety of services, at varying prices: The house sellers that want "full service" from their agents would continue to be able to receive such service, at a "full service" (but competitive) price; and sellers who want lesser levels of service – picking and choosing among an "a la carte" menu of possible individual services[6] -- would be able to get those levels of service as well, at appropriate prices. This latter phenomenon -- the opportunity for greater variety that better suits clients' preferences -- is a sometimes overlooked but nevertheless important benefit from a more competitive outcome. The role of the buyer's agent could well change also.

This paper will proceed as follow: In Section II we will provide some background on the industry and the competition issues. In Section III, the story of securities brokerage commissions will be summarized. Section IV will draw on the securities brokerage experience to offer predictions as to the likely outcome of a more competitive framework for real estate brokerage. And Section V offers a brief conclusion.

2. Some Background

A residential real estate transaction -- buying or selling -- is probably the largest financial transaction that most individuals will experience in their lives. Nowadays, the typical transaction involves a sales/purchase price that is well into six figures,[7] and seven-figure transactions are becoming commonplace in many areas. Most individuals engage in such transactions relatively

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against the NAR was the most recent example.

[6] Nadel (2006) lists eight separate services that a seller's agent can provide: (1) listing the home in the local MLS; (2) setting an appropriate asking price; (3) advertising beyond the MLS: newspapers, online, alternative MLSs; (4) staging a home: interior decorating, cleaning, repairs, etc.; (5) arranging visits by potential buyers, including open houses; (6) securing bona fide offers and feedback; (7) assisting in negotiations; and (8) handling closing – everything after a buyer's offer has been accepted.

infrequently.

In these circumstances, the large sums and the lack of familiarity mean that errors in transacting may occur and can be costly. In turn, this means that sellers and buyers are likely to turn to specialists/experts to assist in the transactions -- to be their agents. And, also in turn, political pressures build for governments to establish mechanisms that try to ensure that the agents can be trusted.

The remainder of this Section will expand on these themes.

The structure of agency

Though some home owners contemplating sale serve as their own agent (this is described in the trade as "for sale by owner", or FSBO),[8] most choose to hire an "exclusive" agent for a specified period of time: Only that agent can represent the seller in the transaction (and earn the fee that will be paid by the seller) during the specified time period.[9] The agent may be a solo agent/broker, or she may be one of a number of agents that are employed by or are associated with a broker (who will retain a fraction of the agent's fee).[10]

The agent advises the seller as to an appropriate asking price for the house and also advises on pre-sale strategies to make the house more presentable to potential buyers, etc. She then "lists" the house as available for sale and treats the "listing" as her "property".

Potential buyers of houses also turn to real estate agents for assistance and guidance. Accordingly, in her ideal setting, the listing (sell-side) broker will also find a suitable buyer and thus earn the full commission on the sale. Next best, from the perspective of the brokerage firm that employs her, is that another agent in the same firm will be the one to find the suitable buyer (so that the two agents split the fee, with the broker retaining some fraction of both agents' fees).

However, since there are usually multiple real estate brokerage firms in any community, the

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[7] The NAR reported that the median sales price for existing one-family homes in February 2006 was $209,000.

[8] Nadel (2006) estimates that FSBOs account for 15-20% of residential sales.

[9] Agents worry, legitimately, about the possibilities of others' free-riding on their efforts. For example, in the absence of a contract that specified exclusivity, the initial broker might undertake substantial efforts to sell the house -- and then when a likely buyer was on the verge of making an acceptable offer, the owner might side-step the agent and negotiate directly with the owner (or use a lower-priced intermediary who had not incurred all of the costs of the initial broker).

[10] In the terminology of the real estate industry, an "agent" is someone who has an agent's license (from the state where she works), for which she need not have any prior experience in the industry. Agents usually work for "brokers", who have a more advanced license that requires some years of experience. The discussion in this paper will largely ignore this distinction and will generally refer to the individuals in the residential real estate selling/buying business interchangeably

real estate industry in most communities long ago realized that these multiple brokerages could mutually benefit by jointly placing their listings into a common pool -- a "multiple listing service" (MLS) -- that could be accessed by all brokerages. In so doing, each agent widens the range of the buy-side customers to which her sell-side listings can be exposed. At the same time, each agent gains access to the others' listings and thus might succeed in connecting one of her potential buyers with another brokerage's sales listing. In essence, both buyers' and sellers' transactions costs are reduced, since a buyer can thereby visit only a single brokerage but still have access to all brokerages' listings, and a seller can thereby gain access to all potential buyers.

In the event that brokerage B finds the buyer for brokerage A's listing, the selling agent's fee is usually split 50-50 with the agent who found the buyer.[11]

The potential for collective market power

On the surface, the structural characteristics of the industry would seem to make the collective exercise of market power unlikely. In most communities of any size there are more than two or three brokerage firms, and entry is easy. In such circumstances, collusion (explicit or implicit) is usually difficult to implement.

There are, however, two structural features that make the collective exercise of market power more feasible than would otherwise appear to be the case. First, because the MLS has been a powerful mechanism for encouraging efficient information dissemination by house sellers and efficient searching by home buyers, if a brokerage firm were to be unable to contribute its sell-side listings to its local MLS and/or be unable to access the local MLS on behalf of its buy-side customers, it would be at a substantial disadvantage vis-a-vis its MLS-member rivals in attracting both sell-side and buy-side customers. Thus, the ability of the collective members of a MLS to exclude rivals -- especially if those rivals are "mavericks" who are price-cutters with respect to commissions -- can be a powerful way of enforcing a high-fee structure and thus of maintaining the

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as agents and brokers.

[11] Note that this structure reduces fears of free-riding on the part of the broker who finds the buyer. Since the seller is committed to whatever fee has been negotiated with the selling agent (who will split it with the agent who found the buyer), there is no gain to the buyer to try to negotiate directly with the seller or to use a different agent just to reduce costs -- unless the selling agent would be willing to split the fee directly with the buyer, or a different buyer's agent would be willing to rebate part of her fee to the buyer. An alternative way of dealing with these latter possibilities would be for the buy-side broker to negotiate an exclusivity contract with her buyer that would roughly parallel that of the listing broker with her sell-side client.

collective exercise of market power.

Second, most real estate agents operate on both the sell-side and on the buy-side -- i.e., they try both to find listings and to find buyers. Thus, unlike competitors in most markets, they are frequently interacting in vertically related ways that require cooperation in order for completed transactions to occur. Today broker A may represent a seller and broker B may represent a buyer; tomorrow the reverse may be true. This sell-side/buy-side reversible interaction provides a concrete means whereby agents who are the upholders of high fees can threaten to or actually discipline price-cutting rivals, even in the absence of a MLS. A high-fee-upholding agent who has a potential buyer may threaten to or actually boycott the listings of a price-cutting seller's agent.[12] Similarly, a high-fee-upholding agent with a listing may make it difficult for a fee-cutting agent to bring buyers to see the property.[13] Much of this "steering" can happen without any formal agreement among the agents to maintain high fee levels, especially in a social climate where the importance of maintaining high fees is frequently discussed and remarked upon in informal settings.[14]

Fee rigidity as an indicator of inadequate competition

In principle, the fee (or commission) for the agent's services is negotiable; in practice, historically, there has been a substantial tendency for the fee to be a fixed percentage of the selling price of the house -- usually 6% or 7%, depending on the community -- regardless of the magnitude of the sale price.[15] Thus, if one house sold for twice the price of another house but the agents in both instances quoted and were paid the same percentage fee, the fee amount earned by the agent for selling the first house would be twice the fee amount earned by the second agent.

This last point is worth stressing. If the agents' costs of selling the two houses were

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[12] Since the standard 50/50 split of fees between the sell-side and buy-side agents reinforces the incentives of a buy-side agent to steer a client first toward the listings of a full-fee agent, it may be difficult in practice to distinguish between such "natural" avoidance of the listings of a fee-cutting agent and a more sinister boycott that is intended to discipline the fee-cutter.

[13] That such "steering" on either the buy-side or the sell-side is not in the interests of the high-fee-upholding agent's *customers*, and thus is contrary to the agent's fiduciary obligation to her customer, is clear; but, in a milieu where there is a great deal of uncertainty as to which house will best fit the demands of a buyer and which buyers are true prospects for a seller, it may be difficult for the client to determine that her agent is steering in a disadvantageous way.

[14] There are at least two other troubling market situations that we note below where agents participate on both the buy-side and the sell-side, with frequent reversals of roles and concomitant opportunities for freezing out "mavericks": NASDAQ securities dealer transactions, and underwriting fees for initial public offerings.

[15] The evidence supporting this claim is summarized in Hsieh and Moretti (2003) and GAO (2005). As Nadel (2006) points out, this fixed percentage also causes potential differences in the quality of the services that different listing brokers might offer to sellers to go unrewarded.

approximately the same (in terms of time, effort, advertising, etc.), then we would expect that competitive pressures would cause agents' fees to approximate those costs (including a competitive profit return on invested capital), thus leading to a tapering of the percentage fee with respect to higher-value houses. Even if the costs of selling a more expensive house were greater than those of selling a less expensive house, it seems unlikely that the selling costs of the former would be proportionally greater (as is implied by the rigidity of the percentage fee).

Of course, in any line of business the quoted fees may well fall into patterns, and the use of round numbers, standard fractions, etc., would be expected. Thus, it seems unlikely that any real estate agent would quote or be able to defend a fee of "6.078% of the sales price" to any prospective seller.[16] But, still, depending on the likely selling price of a house and the agent's expectations as to the costs of selling, percentage fees that employed standard fractions -- say, 5-3/4% for a low-value and difficult to sell house and 4-1/4% for a higher-value and easy to sell house -- could well be expected in a competitive environment, rather than the extreme pattern of just 6%. Further, to the extent that there are fixed costs that are associated with the agent's efforts (say, the initial consultation with the sellers) and also costs that vary with the expected selling price (say, more advertising for a more expensive house), a two-part fee -- e.g., $2,000 plus 3% of the selling price -- would be expected in a competitive environment. The total amount of this two-part fee, when expressed as a percentage of the selling price, would exhibit the expected taper.

Further, as was noted above, a fixed percentage fee announced by most or all brokers in a metropolitan area prevents the inherent quality differences that surely exist among brokers from being rewarded. It has frequently been noted that sellers that are attempting to coordinate their pricing behavior at above-competitive levels will usually favor simple pricing schedules over more complex ones, even if this simplicity means that quality differences go unrewarded.[17]

There are two other indicators that, in conjunction with fee rigidity, suggest something less than vigorous price (fee) competition among real estate agents. First, at times of surges in housing prices -- but constant fee percentages, which would imply rising profits -- there have been surges of entry into the ranks of real estate agents. For example, as of year-end 2000 the NAR reported membership of 766,560 Realtors; five years later (and concomitant with a widely publicized surge in

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[16] Or, as Schelling (1960, p. 67) observed, the automobile salesperson who declares that the lowest possible price for a car is $2,507.63 is almost pleading to be relieved of $7.63.

[17] See, for example, Stigler (1964, 1968).

house sale prices), at the end of 2005, the NAR reported that its membership had jumped by over 65% to 1,265,367.[18]

Second, there have recently been a number of sell-your-house-yourself books,[19] emphasizing the large sums that can be saved through a FSBO that avoids or greatly reduces the use of a broker. If real estate commissions were at competitive levels, the temptations for do-it-yourself FSBOs would be muted.[20]

Government regulation

As was discussed above, the relatively large size and infrequency of residential real estate transactions would be expected to attract political concern and consequent governmental efforts to protect the households involved in such transactions. Not surprisingly, then, all 50 states (and the District of Columbia) have governmental agencies that have responsibilities for licensing real estate agents and brokers, as well as involvement in other aspects of residential real estate transactions.[21] These state agencies often have the title "Real Estate Commission" or "Department of Real Estate". The first such agency was authorized by the state of Arizona, in 1912. Also not surprisingly, there is a national association of these agencies -- the Association of Real Estate License Law Officials (ARELLO) -- that compiles records and statistics and holds annual conventions.[22]

The primary goal of these agencies is consumer protection. However, there are often conflicting views of what constitutes appropriate consumer protection -- and in some instances the agencies have adopted regulatory requirements (all in the name of consumer protection) that clearly favor incumbent full-service real estate agents at the expense of agents who would provide more price competition.[23] These requirements include prohibitions on buyers' agents rebating a part of

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[18] Hsieh and Moretti (2003) provide an estimate of the substantial costs of excessive entry and excess capacity yielded by the combination of fixed fees and free entry. It is also worth noting that the estimate mentioned in the Introduction of about two million individuals that are active as real estate brokers or salespersons represents well over one percent of the U.S. labor force.

[19] See, for example, Carey et al. (2004); Nadel (2006) provides an extensive list of such books.

[20] And, to anticipate the securities brokerage commission history that is recounted below, there were extensive try-to-avoid-the-broker strategies that were prevalent during the fixed-commission period of the 1960s. These efforts disappeared after brokerage commissions became competitive in 1975.

[21] For example, many states also license mortgage brokers, establish escrow rules, license appraisers, etc. See ARELLO (2006).

[22] Forty-eight states, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands are members; Minnesota and Wisconsin are not.

[23] It is worth noting, however, that the state agencies have not generally adopted licensing requirements that are so

their fee to the buyer (which has obvious direct implications as to limitations on price competition and indirect implications as well, since rebates by buyers' agents might put fee-reduction pressures on sellers' agents) and mandatory minimum service requirements for sellers' agents, thereby eliminating competition from discount brokers whose primary service would be to provide access to a MLS.[24]

3. The Parallels with Another Brokerage Industry: Securities

There is an interesting parallel between the fixed commissions that have pervaded the real estate brokerage industry and the fixed commissions that at one time (prior to December 1968) were the rule for buying and selling equity securities that were listed on the New York Stock Exchange (NYSE). This section will briefly review the story of NYSE fixed commissions, the arguments that the NYSE advanced to defend its system of fixed commissions, and the consequences of the onset of "negotiated" (competitive) commissions.[25]

The NYSE's fixed commissions

Prior to 1968, stock brokerage commissions for buying and selling NYSE stocks were uniform across all NYSE members. They were set collectively by the NYSE members, with automatic approval by the U.S. Securities and Exchange Commission (SEC). The commission rate was set at a certain amount per "round lot" (i.e., 100 shares), with no discount for volume; thus, the commission for the sale or purchase of 1,000 shares was ten times that of the commission for the purchase or sale of 100 shares. Further, the round-lot commission was higher for higher-priced stocks than for lower priced stocks. During the 1960s, the commission to buy or sell 100 shares of a $20 stock was $27; for 100 shares of a $40 stock it was $39; for a $60 stock it was $45; and for an $80 stock it was $47.[26]

Both features of this schedule contravened the likely costs involved in stock brokerage. The costs of trading blocks of stock that were multiples of a round lot may have been somewhat higher

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stringent as to constitute a serious barrier to entry into becoming a real estate agent or broker.

[24] The GAO (2005) report provides the examples and the states that have erected these anti-competitive restraints, as of mid 2005; Nadel (2006) provides additional examples.

[25] This narrative draws extensively on Baxter (1970), West and Tinic (1971), Friend and Blume (1973), Stoll (1979, 1981), Tinic and West (1980), Jarrell (1984), and Matthews (1994).

than the costs of trading just a round lot, but they surely were not strictly proportional; and the costs of trading a $40 stock were likely to be only moderately different from those of trading a $20 stock or an $80 stock.

The decade of the 1960s was one of a major increase in the relative importance of "institutional" ownership of and trading in shares of stock. Mutual funds, pension plans, insurance companies, and bank trust departments were increasingly important "players" in the securities markets and specifically in buying and selling shares of stock on the NYSE. Their size meant that they were likely to be trading blocks of stock that were multiples of round lots. The disparities between the NYSE's fixed commissions and the likely true costs of the stock brokerage activity being undertaken[27] were all too apparent to these institutions.[28]

Their response was predictable. Faced with an unyielding NYSE,[29] they tried to find alternative means of reducing their transactions costs. These included:

- Obtaining in-kind services from brokers in exchange for bringing the institution's highly profitable trades to the brokers. The services could include specialized securities research. In addition, a mutual fund might obtain a commitment by the broker to sell the mutual fund's shares to the broker's clients.

- Directing the broker to "give-up" part of the commission to another NYSE member, from whom the institution had obtained services (typically, research). Such give-ups were banned by the NYSE in 1968.

- Trading in "the third market"[30] -- i.e., in dealer-mediated transactions away from the NYSE, where commissions would be lower. But these markets were thin and not well suited to the large-block transactions that were the source of the institutions' unhappiness with the NYSE's fixed commission schedule in the first place.

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[26] See Stoll (1979).

[27] See Stoll (1981, p. 20) for one such estimate.

[28] One interesting difference between the consequences of fixed commissions for NYSE members and fixed commissions for real estate agents is that, unlike the relatively free and easy entry into real estate brokerage, the number of seats on the NYSE were fixed at 1,366. Thus, rather than the potentially high profits from the fixed fees and rising volume of large-block trades being shared with entrants (as has been the case in real estate), the high profits instead were capitalized into rising prices of seats on the NYSE. The price of a seat on the NYSE more than tripled between 1960 and 1968. See Stoll (1981, p. 23).

[29] There is a parallel between the central role that the NYSE played as a place for sellers and buyers of securities to transact and the somewhat similar role that the MLS plays today as a central place for sellers and buyers of residential real estate to learn about each other.

- Trying to join (i.e., buy seats on) the NYSE so as to save on commissions. The NYSE established rules that stymied such efforts.

- Trying to join regional exchanges (e.g., the Boston, Philadelphia-Baltimore-Washington, Chicago, or Pacific Exchanges), so as to be able to trade on those exchanges at more reasonable commissions. Though some institutions did succeed in joining a regional exchange, the thinness of trading volumes on these exchanges again made them unsuitable for the large-block trading that was the source of the institutions' unhappiness with the NYSE's fixed commissions.

These institutions' pressures, plus that of the Antitrust Division of the U.S. Department of Justice (DOJ), led the SEC to hold hearings in 1968 and, in December 1968, to order the first break from the NYSE's fixed commissions: Volume discounts were required. Subsequently, the SEC mandated (in 1971) that the commissions on the portion of an order that was over $500,000 should be negotiated and (in 1972) that the commissions on the portion of an order that was over $300,000 should be negotiated. Finally, on May 1, 1975 (known for many years afterward as "May Day" in the securities industry), all brokerage commissions, regardless of size, became fully negotiable.[31]

The NYSE's arguments in favor of fixed commissions

In the late 1960s and early 1970s, the NYSE resisted the idea of negotiated (competitive) commissions. It offered an array of arguments:

(a) The brokerage industry was characterized as capital-intensive and therefore dominated by high fixed costs and low marginal costs; unrestrained ("destructive") competition would lead to prices (commissions) that equaled those low marginal costs, which would not allow the industry to recover its fixed costs, and thereby lead to industry dis-investment.

(b) Price (commissions) competition, and the dis-investment that followed, would lead to massive consolidation of the industry, with an eventual oligopolistic structure that would generate less competition and higher commissions.

(c) Competition would lead to fragmentation of the securities markets, with the consequence of poorer execution for buyers and sellers.

(d) Competition would mean the end of cross-subsidization, whereby the profits on the large

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[30] The NYSE and the American Stock Exchange were considered to be the "first" and "second" markets, respectively.

[31] The May 1, 1975, date for fully negotiable commissions was specified by SEC regulation. To ensure that competition could not be undone by future regulatory changes by the SEC, the Congress mandated it in the Securities Acts

institutional orders were being used to cover losses on the smaller orders of individual investors ("the little guy").

(e) Competition on price (commissions) would mean that customers would not be provided with the services that they needed, especially advice and research.

(f) The securities markets, and the firms that made those markets, had served the U.S. economy well; why take chances with an untried proposal?

The proponents of price competition had counter-arguments to each of these propositions.[32] Fundamentally, their argument was that the securities industry was not sufficiently different from most other industries in the U.S. economy; if competition was the norm (and served the U.S. economy well) in those industries, why should this not be true for the securities industry also?

In the end, it was the proponents of competition that carried the day.

The consequences of competitive commissions

Brokerage commissions began to fall on large orders in the early 1970s, commensurate with the SEC's loosening of the restrictions on large orders in 1971 and 1972. With the full opening of competition on May 1, 1975, commissions fell further. The greatest and fastest decreases (as would be expected) were for the larger block trades by institutions; despite the reductions that had already occurred before 1975, commission rates fell another 50% by 1980. By the late 1980s rates had fallen a further 25% from early 1980s levels.[33]

Commission rates for individuals experienced a more varied pattern. Commissions on low-volume trades actually increased (which supported the NYSE's claims that these transactions had been cross-subsidized). But the commissions on higher volume trades for individuals declined, so that average commissions for individuals also fell (though not by as much as for institutions).

Amendments of 1975.

[32] Briefly: (a) The fixed costs of the industry were not as great as the NYSE claimed, so that the destructive competition envisioned by the NYSE was unlikely; (b) The securities industry was likely to remain profitable for efficient firms in the industry, so dis-investment was unlikely, and with hundreds of securities firms present in the industry (as of 1970, there were 577 firms that were members of the NYSE, with about 500 "doing a public business"), there was virtually no chance of a consolidation that could lead to an oligopolistic restriction on competition; (c) Fragmentation was already occurring, *because of the NYSE's fixed commissions*, as institutions sought other venues for trading; (d) If cross-subsidy was indeed occurring, its elimination through competition would probably be a desirable outcome; (e) If securities transactors needed and wanted advice or research, they should and would be willing to pay for it; and (f) Competition is the norm for industries in the U.S. economy and should apply as well to the securities industry.

[33] See Jarrell (1984) and Matthews (1994, p. 132). With the onset of competitive rates, the institutions' efforts to avoid the NYSE's brokers' commissions (i.e., all of the efforts detailed above, such as trying to join the NYSE itself, seeking

Equally important, with the end of fixed commissions, an alternative business model for brokerage arose for the first time: "discount brokers", who offered reduced services (primarily bare-bones execution, without offering advice or research or well-appointed offices where customers could congregate and watch the ticker-tape) at reduced commissions.[34] Firms, such as Schwab, Muriel Siebert, Brown & Co., Waterhouse, Quick & Reilly, and National Discount, offering various levels of services at various prices, came into prominence. In addition, a number of mutual funds, such as Fidelity and Vanguard, established discount brokerage subsidiaries, as did some commercial banks that entered the brokerage field. The presence of the discount broker model offered an important alternative choice for customers who did not want the "full service" of the traditional securities firm and wanted instead an unbundled or "a la carte" choice of services.

Much later in the 1990s, as electronic placement of orders via the Internet became a viable alternative to more traditional methods of placing orders, at much lower costs, this model too was embraced by a segment of the industry, many of them originally discount brokers and some of them new discount entrants (such as E*Trade and Ameritrade), with appropriately lower prices.

Finally, the industry did indeed experience substantial consolidation subsequent to 1975.[35] But, as of 2006, there are still well over 200 securities firms that "do a public business"; seller concentration levels remain moderate; there are dozens of discount brokers, in a well-established category;[36] and oligopolistic forbearance in the pricing of brokerage commission transactions with the public is not considered to be a problem in the securities industry.[37]

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give-ups, etc.) quickly subsided.

[34] It is important to emphasize that this discount broker model could not have arisen prior to the end of fixed commissions. If otherwise competitive sellers are allowed to charge only a single (floor) price for their basic service (i.e., they are not permitted to compete on price), and this floor price exceeds their marginal costs of that service, then their competitive efforts will instead be channeled into providing greater services to their customers. Since a low-service seller could not charge a commensurately low (discount) price, it would be at a competitive disadvantage in this mandated price-floor environment. See, for example, White (1972).

[35] As of 1974 the four-firm concentration ratio for all securities firms doing a public business (based on total capital) was 29.4%, and the Herfindahl-Hirschman Index (HHI) was 460; by 1991 these figures had risen to 55.6% and 830, respectively (Matthews 1994, p. 109). As of 1974, there were 508 firms that were members of the NYSE, with 420 "doing a public business"; by 1991, these numbers had changed to 518 and 329, respectively; by 2004 they were down to 321 and 229, respectively. A different series developed by the Securities Industry Association shows the share of the largest 10 firms (based on total capital) at about 50% in 1980, rising above 60% in the early 1990s, and then falling to about 55% in 2000-2001.

[36] The category of discount brokers, when measured by number of employees, exceeds 10% of the size of the category of "national full-line firms".

[37] As we noted above, there are two troubling areas of the securities industry where there has been and/or may well be less than vigorous price competition: First, in dealer transactions in NASDAQ securities, settlements of price-fixing cases involving over $1 billion were reached in the later 1990s. But this was a problem of collusion among large

In sum, virtually all of the fears raised by the NYSE in its struggle to maintain its system of fixed and non-competitive commissions (except its argument concerning cross-subsidization) turned out to have little validity. The securities industry successfully made the transition to a competitive environment without serious dislocations.

4. The Consequences of More Vigorous Competition for Residential Real Estate Brokerage

In this section we will use the experience of the securities industry to explore the likely consequences of more vigorous competition in the residential real estate brokerage industry. We also suggest public policy actions that could help bring about that heightened competition.

What would more vigorous competition look like?

The story of stock brokerage commissions, just recounted, provides a reasonably good model for predicting what true competition for the residential real estate brokerage industry would look like.

First, the general level of commissions would surely fall. Because no one knows exactly what a competitive real estate brokerage industry would look like, it is difficult to predict by how much the general level of commissions would fall. Further, the extent of the fall would surely be influenced by the pace of innovation and change in the technology of selling real estate -- which again is difficult to predict. (Those who advocated the end of fixed commissions on the NYSE were confident that competitive commissions would mean lower rates -- but it is unlikely that anyone circa 1975 could have predicted the sharp decrease in rates that accompanied the onset of electronic trading in the late 1990s.) Nevertheless, the direction of change -- downward -- is clear.

Second, as occurred in stock brokerage, we would expect to see a greater variety of services available to sellers, and a variety of (competitive) prices. Those sellers who wanted "full service"

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numbers of dealers (who interacted on both sides of these dealer markets), rather than a problem of small-numbers oligopolistic coordination. See, e.g., Christie and Schultz (1994, 1995). Second, the fees charged by underwriters for initial public offerings (IPOs) -- i.e., for new stock offerings by companies that are "going public" for the first time -- have tended to clump at 7%. In this latter area, two of the characteristics that make real estate brokerage troubling are also present for IPOs: For many small-company executives, an IPO is a first-time (or, at best, infrequent) experience; and the underwriter firms frequently interact as primary underwriters and as secondary distributors (and frequently reverse roles), so that the possibility of freezing out "maverick" price-cutters (commission-cutters) is present. For a general discussion of the persistence of high underwriting fees, see Chen and Ritter (2000).

would be able to obtain it, from a full-service broker and at a full-service competitive price. Those who wanted lesser levels of service would also find them and at lesser (competitive) prices.

Third, new arrangements with respect to buyers' agents might well arise. The current standard arrangement -- that the buyer's agent's fee comes from half of the seller's agent's fee -- may well be an incidental artifact of the current fixed-fee brokerage structure. If sell-side commissions become more competitive (or much reduced because of reduced services provided by sell-side agents), then buyers may have to compensate their agents directly (as, of course, occurs in securities transactions). As we noted above, in order for buyers' agents to circumvent potential free-rider problems, they may have to negotiate exclusivity contracts with buyers. It seems likely that a competitive market in residential real estate brokerage would be able to find its way to an efficient structure for these fees on both the sell-side and the buy-side.

Fourth, as new technologies for selling and buying residential real estate become feasible, a more competitive industry would readily embrace them.

Fifth, with more competitive commissions that react flexibly to changes in house prices, the surges of people into (and out of) real estate brokerage[38] should be considerably muted, as should the problem and costs of excess capacity noted above.[39]

Sixth, as occurred in securities brokerage, we would expect to see consolidation in the residential real estate brokerage industry. There would likely be further expansion by existing national brokerage firms, as well as the development of new ones. Nevertheless, we would expect to see the persistence of some local brokerage firms, since local expertise is surely valuable but may well be difficult to maintain and value in a larger national organization. And, so long as the barriers to entry remain relatively low, the levels of brokerage concentration in any local market should remain moderate and should present little structural antitrust concern (although the concerns about the use of the MLS as a vehicle for freezing out mavericks and about the sell-side/buy-side

[38] We mentioned above the 65% surge of NAR membership between 2000 and 2005. By contrast, between 1980 and 1982, NAR membership fell by 19%, from 761,391 to 617,521.

[39] Nadel (2006) mentions travel agents as a service sector in which commissions have become more competitive, as airlines ceased paying them a fixed percentage commission and as more airline customers used airline (and related) Internet websites directly to book their travel. It is possible that wider use of the Internet by house sellers and buyers, with the help of alternative central websites, such as "Craig's List", could similarly reduce the role of the MLS and of real estate agents' services as related to listing on the MLS. There is still likely to be a role for real estate agents as advisors to sellers (an "a la carte" list of disaggregated services was noted above) and as advisors to buyers, just as travel agents still provide advice to travelers.

interactions and their implications for freezing out mavericks should remain).

How could we get there?

The more competitive residential real estate brokerage sector that has just been described is unlikely to arise without some help from sensible public policy. The anti-competitive tendencies of the incumbent industry seem quite powerful and will need neutralization. The following three recommendations should help.

First, entry by banks -- currently impeded by the absence of enabling legislation by Congress and/or regulatory approvals by the Federal Reserve[40] -- should be unblocked. Banks would be new players, from outside the existing culture of the residential real estate brokerage industry. This "outsider" identity, by itself, would be extremely valuable for introducing aggressive competition into the industry. Further, it is worth noting that banks, when entering securities brokerage, often found that discount brokerage was an appropriate strategy for their entry. Since discount brokerage in real estate transactions is still relatively rare, having banks (with their brand name recognition) as purveyors of this form of service (if that is the route that they choose) would likely be an extra benefit.

The prospect of banks' entering any field outside of traditional banking almost always raises two sets of concerns. One concern is bank regulators' fears that the new service might somehow undermine the safety and soundness of banks. However, there are straightforward ways of dealing with these fears.[41] If bank regulators understand the service and can set appropriate capital standards and competency standards (as they do for traditional bank services), then the service can be provided directly by the bank, and the traditional structure of bank safety-and-soundness regulation can be extended to this service as well (when, and only when it is provided by a bank[42]). If the service is not appropriate for a bank itself, then it can be provided by a bank holding company or by a separately capitalized subsidiary of the bank (with appropriate scrutiny by bank regulators that any

[40] See Hahn, Litan, and Gurman (2005) for more details.
[41] See Shull and White (1998) for an elaboration of these arguments.
[42] This caveat is important. The bank regulators' legitimate concerns about the safety and soundness of banks should not become the excuse for regulating residential real estate brokerage more broadly. The analogy with lending is worthwhile. Though bank regulators' concerns about safety and soundness are legitimate with respect to bank lending, they are not applicable (and do not apply) to lending by finance companies, factoring firms, or other entities (including individuals) that make loans. These safety-and-soundness concerns are different from wider societal concerns about things like inappropriate discrimination by lenders, which does have wider regulatory applicability.

transactions between the bank and its holding company or subsidiary are on arm's-length terms).

The other concern about bank provision of non-traditional services is that this expansion of banks' services will somehow enhance the banks' perceived economic power and/or the banks will act in a predatory manner so as to drive out their non-bank competitors and then raise prices above competitive levels. This second concern, as well as the concern about safety and soundness, was raised in the discussions of banks' being permitted to enter the securities business.[43] Those concerns proved unfounded in that area. It seems likely that they would be unfounded with respect to residential real estate brokerage as well.

Second, the Antitrust Division should maintain a high level of scrutiny with respect to the use of MLSs as exclusionary devices and with respect to local groups of real estate agents excluding mavericks in the ways that have been described above. The NASDAQ dealers case provides a good object lesson in the dangers of markets that have sell-side/buy-side interaction characteristics that make them conducive to freezing out mavericks and the necessity for high levels of scrutiny.

Third, the Division and the FTC should continue their efforts at vigorously lobbying (and even suing) the states so as to urge pro-competitive actions on the part of their licensing agencies.

Finally, any advocacy of public policy actions to encourage greater competition should acknowledge the possibility of a "law of unintended consequences". In the case of securities commissions, greater competition meant reduced profits for the industry from that line of business, which led to increased emphasis on investment banking and the eventual scandal of excessive promotion of securities under the guise of "research". With respect to residential real estate commissions, one possible reaction of the industry to heightened competition could be a lobbying effort to convince the states to tighten licensing procedures severely so as to restrict entry into the industry.

Predicting such "unintended consequences" is, of course, exceedingly difficult. But the main point remains: Policymakers should be on their guard against such consequences.

5. Conclusion

The residential real estate brokerage industry is an important one for the U.S. economy.

[43] See, e.g., Goldberg and White (1979) and Walter (1985).

Over 1% of the U.S. labor force has real estate licenses; in 2004 $61 billion in commissions were paid in connection with home sales.

More vigorous competition is clearly possible and desirable. The experience of the securities industry three decades ago is instructive in this respect. Self-serving arguments by the real estate brokerage industry against more vigorous competition ought to be disregarded, just as were similar arguments by the securities industry 35 years ago. Public policy can and should play a role in pushing the real estate brokerage industry in a more competitive direction. The results could only be favorable for house sellers and buyers alike.

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