



Graduated Commissions

By Brian Madigan

If you read *Freakonomics* by Steven Levitt and Stephen Dubner, you will have the impression that realtors are not particularly interested in getting the best price for your property.

The reason according to the authors is due to the fact that during the final negotiations the realtor doesn't have as much to lose as the homeowner. The authors are economists and their analysis is pure economic theory, but it doesn't really work quite that way in the real world.

So, let's have a look at what they say. Let's assume that you are selling your house and you have agreed to pay a 5% commission based upon the ultimate sale price. You have it listed at \$ 309,900.00 and you are hoping to get it sold for \$ 300,000.00. If that occurs, then, you will pay \$ 15,000.00 in commissions. So let's say you get an offer for \$290,000.00. You would lose \$ 10,000.00, but the agents would only lose \$500.00, because the commission on the lower amount is still \$ 14,500.00.

If the sole and only motivation for your agent was the money, then, they should convince you to do this deal and move on to another client. In fact, of the last \$ 10,000.00 in the deal, your own agent may only get \$ 62.50, so that's not much motivation at all. Here's how that works: the additional commission is \$ 500.00, and that's split equally between the two brokerage firms, one for the purchaser and one for the vendor. Your agent might only get one half of the commission based on their own arrangements with their own broker, so now we're down to \$ 125.00. But, that's not the whole story, Canada Customs and Revenue Agency will probably take one half of what's left. So, the bottom line is if you sell for \$ 300,000.00 rather than \$ 290,000.00 your chief negotiator will get another \$ 62.50. That's not much of an incentive!

The economists are suggesting that the better deal would be to have the agent motivated by re-directing commission entitlements to the tail end of the deal. So, what if we had graduated commissions; the higher the price the

higher the rates. Taxing authorities do this same thing. The higher the income, the higher the rates. Let's presume that the commission at the tail end of the deal was 50%. For example, nothing on the first \$ 250,000.00 and all the commission payable out of the excess above \$ 250,000.00.

Now, I'm not talking about the total amount of commission, I'm going to assume that the \$ 15,000.00 is reasonable. But, under the system suggested by Levitt and Dubner, the entire \$ 15,000 would have to come out of the last \$ 50,000.00 of the purchase price. And, let's assume that by the time we get to \$ 290,000.00, one half of the excess goes in commissions. So, who cares about the final sale price now? Presumably, the agents care, more than you care. It's one-third of the total commission payable. Yet your own agent may still only get 1/8 of that amount (1/2 other agent, 1/2 broker, 1/2 tax) or \$ 625.00. So, while it seemed like a lot of money to put on the table to create an incentive, it's really not that much.

So let's move it up to 75%, that's \$ 7,500.00 in commission out of that last \$10,000.00 (yet only \$ 937.50 to your own agent); or 90% that works out to \$ 9,000 and \$ 1,125 to your agent. Now, out of that last \$ 10,000.00, your agent finally has more at stake than you do. So, that should be a real motivator. And then, what about the final step, 100% of the last \$ 10,000.00? So, this would work out well. You don't even care about the final sale price.

The problem here is the law of agency. The common law is designed to ensure that the agent meets all of the legal obligations to the principal. It's the principal's contract, not the agent's. Contingency fees for lawyers were outlawed until the latter part of the last century in most jurisdictions, for much the same reason. Now, fees of up to about 30% subject to Court approval are permitted.

The 100% commission under discussion is the same thing as a guaranteed price with the agent taking the excess. Now there's an opportunity for the agent. This is not particularly professional. It does not comply with the laws governing principal and agents. Most jurisdictions with consumer protection legislation will not permit this sort of an arrangement.

In Ontario, real estate agents and brokers are governed by the *Real Estate and Business Brokers Act* which is administered by the Real Estate Council of Ontario.

Here are the rules when it comes to commission:

The commission may be:

- a fixed amount
- a percentage of the purchase price
- a decreasing percentage of the purchase price

The commission may not be:

- a fixed amount together with a percentage
- an increasing percentage of the purchase price
- the difference between the listed price and the sale price (or any similar arrangement, that is, no guaranteed amount to the vendor with the excess to the agent)

Well, those laws wouldn't sit well with Levitt and Dubner, but then again it's a very interesting discussion for an Economics class. By the way, those big time incentives for professional athletes don't work all that well. Just ask Leaf fans, Yankee fans.....

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