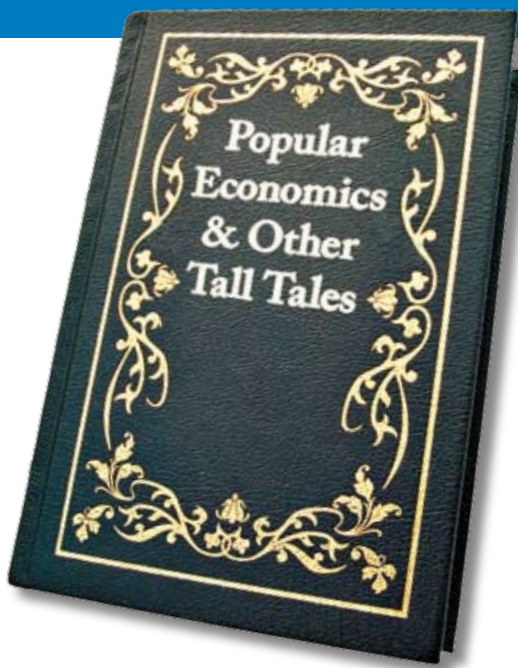




BRITISH COLUMBIA  
REAL ESTATE  
ASSOCIATION

# the bulletin



The best-selling *Freakonomics* is celebrated by the *New York Times* as “a splendid book, full of unlikely but arresting historical details that distinguish the authors from the run of pop social scientists.” Indeed, authors Steven Levitt and Stephen Dubner proclaim to explore the hidden side of everything with so-called “plain old-fashioned economics.” One chapter in their book is called “How is the Ku Klux Klan Like a Group of Real Estate Agents?” While this provocative title may infuriate REALTORS® (being compared to such a sinister bunch would infuriate anyone), it does delve into the interesting theory of asymmetric information.

Asymmetric information occurs when one party to a transaction has more or better information than the other. This informational advantage can lead to inequities where the one possessing the better information gets the better deal. Asymmetric information can be particularly relevant in the principal-agent relationship. The agent usually has more information than the principal and, if their interests aren't aligned, the agent has the potential to selfishly act outside the interest of the principal.

Levitt and Dubner correctly point out that a real estate agent is “better informed about the house's value, the state of the housing market, even the buyer's frame of mind.” In other words, the real estate agent is an expert. However, Levitt and Dubner argue that the agent uses their informational advantage to manipulate the home seller into accepting an offer at a price that's lower than what could otherwise be achieved. In their words, “a real estate agent may see you not so much as an ally but as a mark.”

The authors go on to argue that there is little incentive for an agent to put in the extra effort to gain an additional \$10,000 from the buyer. Because the agent's commission is only a fraction of the extra \$10,000, it's “too puny an incentive” for all the extra work.\* The agent has every incentive, then, to sell the home quickly at a lower price. The bottom line, according to Levitt and Dubner, is that a real estate agent doesn't want to “maximize the house's value”; instead, they use their informational advantage to instill fear in the owner that the home might not sell at all in order to “make the deal” quickly at a lower price.

Gene Epstein is a former senior economist at the New York Stock Exchange and has been *Barron's* economics editor since 1993. His lesser-known book, *Econospinning*, takes dead aim at Levitt and Dubner's analysis of real estate agents and asymmetric information. He calls their work “microeconomic metaphysics” and, with little effort, carves a wide swath through their conclusions.

For instance, Levitt and Dubner conveniently omit the role of the homebuyer and their agent. Epstein asks, “Don't the



By Cameron Muir,  
BCREA Chief Economist

agents who represent the buyers also have incentives that are adverse to the interests of their clients?” If the *Freakonomics* authors' theory is to be believed, then the buyer's agent must also attempt to tilt the playing field in their favour. If the seller's agent has incentive to facilitate a quick sale at a lower price, then the buyer's agent must have an equivalent incentive to facilitate a quick sale at a higher price. To arrange a quick sale, the seller's agent must convince the homeowner to lower his price expectations. However, for the buyer's agent to arrange a quick sale, she must convince the buyer to pay a much higher than expected price.

\*commissions are negotiated in Canada

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## Checklist for Presales

Over the years, thousands of British Columbians have entered into contracts to buy new homes before the construction of their homes had begun or during the construction period. This is commonly referred to as a presale transaction.

This is usually a win-win transaction for both the new homebuyer and the developer. Buyers are able to select the homes they want to buy and developers know, with some certainty, their ability to successfully market and finance the projects they're offering to the market.

For a variety of reasons, now and then, a new real estate development doesn't get built. Even though there are certain

risks associated with presales, there are very few instances where the purchase agreement hasn't been honoured by the developer.

Last year, BCREA created a task force to review this issue. Members, including representatives from the Superintendent's office, Urban Development Institute – Pacific Region, Canadian Home Builders' Association of BC and the Greater Vancouver, Fraser Valley and Victoria Real Estate Boards, concluded that better educated practitioners will result in better educated consumers.

To that end, a presale checklist that draws attention to important information for buyers of homes under

development will be finalized shortly. A full understanding of the issues specific to presales provides buyers with a starting point to determine whether further enquiries, advice or clarification are needed.

Once complete, the checklist will be made available to REALTORS®.

### More information

- Financial Institutions Commission of BC website [www.fic.gov.bc.ca](http://www.fic.gov.bc.ca) (click Real Estate)
- Real Estate Council of BC, *Licensee Practice Manual, Real Estate Development Marketing Act*, beginning on page 212 (general information)

## Economics

Continued from page 1

You may notice that, when fully explored, it all sounds like a zero sum game. If we ignore for a moment that REALTORS® are highly trained in agency law, and that strict attention to the principal's instructions is not only a legal requirement, but also necessary for success in a profession where word-of-mouth reference and reputation are critically important, a thorough analysis of asymmetric information and the real estate agent provides a benign conclusion.

"Why does Levitt [and Dubner] draw [a] distinctly asymmetric conclusion?" asks Epstein rhetorically. It's "because of the asymmetric nature of [their] research." They're guilty of the same manipulation of information they accuse real estate agents of engaging in. "In the real world," says Epstein, "buyers may well have strong feelings about what they want to pay and sellers about what they want to charge. Depending on how agents read those feelings, their desire to get the deal done quickly could lead

to any number of outcomes . . . seller's agents may recognize the need to negotiate a *high* price (emphasis in the original) for the deal to get done at all."

Now that's plain, old-fashioned economics.

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Send questions and comments about *The Bulletin* to:

Editor: Norma Miller  
Assistant: Dana Bidnall

1420 - 701 Georgia Street West  
PO Box 10123, Pacific Centre  
Vancouver, BC V7Y 1C6  
Phone: 604.683.7702  
Fax: 604.683.8601  
Email: [bcrea@bcrea.bc.ca](mailto:bcrea@bcrea.bc.ca)

[www.bcrea.bc.ca](http://www.bcrea.bc.ca)

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