



# What is the role of the asking price for a house?☆



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## ARTICLE INFO

### Article history:

Received 19 August 2014  
Revised 22 March 2016  
Available online 28 April 2016

### JEL:

R00 (General Urban, Rural, and Real Estate Economics)  
R21 (Housing Demand)  
R31 (Housing Supply and Markets)

### Keywords:

Real estate  
Housing  
Search  
Asking price

## ABSTRACT

This paper considers the role of the asking price in housing transactions both theoretically and empirically. Significant fractions of housing transactions involve sales prices that are either below or above asking price, which might suggest that asking price has limited relevance. However, many housing transactions involve a sales price exactly equal to asking price (a fact that has previously drawn little notice), strongly suggesting that asking price does matter. The paper develops a model where asking price is neither a binding commitment nor a ceiling, yet still directs buyer search and impacts sales price. Using novel survey data, the paper provides empirical evidence consistent with asking price playing a directing role in buyer search. Consistent with theory, this effect is stronger for more atypical houses and in bust markets.

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## 1. Introduction

When a house is put on the market, its seller lists an asking price. There are two reasons that this asking price is quite different from list prices for ordinary retail goods. First, buyers may be unwilling to pay the asking price, leading them to negotiate the price down. Although there are exceptions, this usually does not occur in retail markets with posted prices. Second, buyers may compete with each other with sufficient vigor that the sales price is pushed beyond the posted list price. Again, although there are exceptions, this also does not usually occur in posted price markets. It is tempting to conclude from this that a house's asking price is of limited relevance. Whether or not this is true is clearly of great importance. A house is typically the largest single asset in a household's portfolio, and housing as a whole is a significant fraction of aggregate wealth (Tracy and Schneider, 2001). The marketing of housing is thus highly significant to households and to the macro-economy.

This paper considers the role of the asking price in housing transactions both theoretically and empirically. It is motivated by three key stylized facts. First, as noted above, *a house's ultimate sales price is frequently below asking price*. Merlo and Ortalo-Magne (2004) find that the average ratio of sales price to asking price is 96% in a sample of UK sales from the mid-1990s. In US data from the National Association of Realtors, Han and Strange (2014) show that the ratio is also 96% for the same period. Not surprisingly, this means that a very significant fraction of sales are below the asking price (Case and Shiller, 1988 and 2003).<sup>2</sup> Liu et al. (2014) show that this ratio is pro-cyclical using Phoenix data. Taken together, these descriptive statistics show that asking price is certainly not a posted price.

Second, in recent years, *sales price is frequently greater than asking price*. This was once rare. In Merlo and Ortalo-Magne's mid 1990s sample, only four percent of sales were at prices greater than the asking price. Han and Strange (2014) find a similar percentage at the same time in NAR data. Recent years, however, have seen more numerous bidding wars, where price is driven above asking price. The national share of above-list sales rose to around 15% during the 2000s boom. In some markets, the share rose to more than 30%. After the bust, this share fell, but at close to 10%, it

\* We thank the Social Sciences and Humanities Research Council of Canada (Grant Number 435-2012-0062) for financial support. We are also grateful for the helpful comments we have received from Stuart Rosenthal, two anonymous referees, James Albrecht, Edward Glaeser, Jessie Hanbury, Edward Kung, Christopher Mayer, Shouyong Shi and participants in seminars at Cornell University, the University of Toronto, the NARSC Annual Meetings, the HULM conference, and NBER. We further thank Travis Chow and Yousuf Haque for very helpful work as research assistants.

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<http://dx.doi.org/10.1016/j.jue.2016.03.008>

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<sup>2</sup> Case and Shiller (1988, 2003) report 1988 fractions of sales below list well above 50% for the cities of Boston, Los Angeles, Milwaukee, and San Francisco. While the fractions of below list sales are considerably smaller during the boom, their 2003 surveys continue to report significant fractions of sales at prices below list. Carrillo (2013) reports 73% of sales below asking price in a sample of Virginia house transactions.

remains much higher than its typical historical levels.<sup>3</sup> It is worth pointing out that the emergence of bidding wars did not simply replace the old negotiate-down approach. Even at the peak of the boom in 2005, the national average ratio of sales price to asking price was 98%, and the share of below-list sales was 54%. In this situation, the asking price is not a posted price. Neither is it a ceiling nor a floor.

Does this mean that the asking price has no impact on a house's sales price? One might suspect, given the frequency of above- and below-list sales, that housing transactions are simply some sort of auction, with the asking price a largely meaningless initiation to the process. In an English auction, price will be the realization of the second highest buyer valuation. In a Dutch auction, price will depend on the expectation of the second highest buyer valuation. In either case, with a continuous and atomless distribution generating the valuations, there is zero probability of asking price equaling sales price. The only role of asking price in this situation would be to "steer" buyers to particular market segments.

The third key stylized fact—one that has not previously been emphasized—contradicts this irrelevance result: *it is common for many housing sales to involve the acceptance of the asking price.* Case and Shiller (1998, 2003) report high levels of acceptance in both years of their survey. The four city average for 1988 was 27.9%. In 2003, it was 48.4%. They do not, however, comment on this phenomenon in the text of either paper. In a recent survey of homebuyers in a large North American metropolitan area (Genesove and Han, 2012b), one sees a lower share of purchases with sales price equal to asking price, but the fraction continues to be nontrivial, an average of 7.9%. That a finite share of buyers pay the asking price strongly suggests that asking price matters. But the question remains: why does it matter?

This paper's empirical work builds on a model of a home seller's problem where asking price plays an important role. It does so by acting as a ceiling only in some situations. The above discussion makes clear that a house is not like other goods in the sense that its posted price does not have the take-it-or-leave-it commitment force of a typical price posting. In fact, an asking price does have some meaningful commitment. Although there is not (to the best of our knowledge) a legal requirement in any jurisdiction that a seller must accept an offer equal to the asking price, the listing contract with a real estate agent creates a partial commitment of a similar nature by requiring the seller to pay the agent's commission if the seller rejects an unrestricted offer equal to or greater than the asking price. Furthermore, there may be behavioral reasons why a seller may feel committed to the asking price. So it is not unreasonable to believe that there is some commitment in the asking price.<sup>4</sup>

Most models of this commitment treat the asking price as a binding ceiling. In Chen and Rosenthal (1996a,b), the seller sets such a ceiling. Buyers make decisions of whether or not to incur the search costs associated with visiting a house and thus learning whether or not it is a good match. In the simplest version of the model, the seller makes a take-it-or-leave-it offer after the visit with knowledge of the buyer's match value. This allows the extraction of the entire surplus. The commitment to a ceiling price is a way that the seller can commit to limit such extraction, strengthening buyer search incentives. By setting a lower asking price, the seller encourages more buyers to visit, increasing the match quality and willingness to pay of the buyer who is keenest *ex post*. This

result extends to a setting when the seller does not have all the bargaining power. Thus, in this analysis, the role of asking price is to encourage visits. See also Green and Vandell (1998) and Arnold (1999) who also treat the asking price as a ceiling.

Our paper's model of commitment and search, in contrast, does not treat asking price as a ceiling. It is, thus, consistent with all three stylized facts discussed above. The model establishes that the commitment role of asking price remains, even when it is no longer always a binding ceiling. In the state of the world where the buyer accepts the asking price, the buyer enjoys more surplus than under the alternative regime of negotiating with the seller, which allows the asking price to direct search.

The primary difference between our model and Chen and Rosenthal is that it allows for bidding wars as well as accepting the asking price or negotiating down from it. The effect of asking price on visitor utility is different in this case than in Chen and Rosenthal in that buyer utility no longer rises monotonically as asking price is reduced. A decrease in asking price increases the likelihood of a bidding war, so eventually a lower asking price provides visitors with less rather than more probability of encountering a binding ceiling. This translates directly into buyer visit behavior. A seller can encourage more visits by reducing the asking price from the maximum of the support of the buyer value distribution. At some point, however, a reduction in asking price does not encourage more visits because the asking price reduction increases the likelihood of a buyer with a high valuation facing strong competition.

In addition to modeling the role of asking price, the paper carries out an empirical analysis of asking price by considering these and other predictions of the model. This sort of empirical analysis of directed search is completely new to the housing search literature, since data on actual search activity is very rare. This has forced prior researchers to consider the relationship between asking price and outcomes such as time-on-market, rather than search itself.

In order to carry out our empirical analysis, we make use of survey data collected by Genesove and Han (2012b) from a large North American metropolitan area. These data are unique in including the number of bidders on a house, which we use as a proxy for the number of buyers who have a serious interest in purchasing the house. The number of serious bidders is, of course, itself a subset of the number of visitors, and so it captures only part of aggregate buyer search activity. Consistent with the model, we find that a lower asking price increases the number of bidders. Moreover, the negative relationship between asking price and number of bidders is stronger in a bust market than in a boom market. In addition, the asking price also has a stronger effect for an atypical house, as the model predicts. The latter two results come directly from the theory. Finally, we find that in a boom there are fewer below list sales and more transactions with sales price equal to and above asking price.

The paper contributes to the growing literature on housing market microstructure. See Han and Strange (2015) for a recent survey. Our partial equilibrium model of a home seller's problem builds on a long tradition of models of this sort, including Stull (1978), Salant (1991), Green and Vandell (1998), and Arnold (1999). As with Chen and Rosenthal (1996a,b), these papers all deal with the fundamental tradeoff where a reduction in asking price increases visits to the house or the probability of sale. In this context, it has been shown that booms impact housing search (e.g., Novy-Marx, 2009), the negotiation over sales price (e.g., Carrillo, 2013), and future home price appreciation (Carrillo et al. 2015). It has also been shown that the seller of an atypical house is likely to have a longer time-on-market (Haurin, 1988). While these random matching models motivate both our theory and empirical work, there is no role for

<sup>3</sup> Case and Shiller (2003) also report growth in the fraction of sales above-list in the four cities that they survey.

<sup>4</sup> This explanation of why there is a mass point of sales prices is obviously very different than explanations of mass points in housing consumption that rely on a kinked budget constraint, as in Hoyt and Rosenthal's (1990, 1992) analysis of the impact of capital gains taxation on housing consumption.

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