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Testing for Agency Costs in Property Transactions

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Abstract

Agency costs may be incurred when a manager, agent or other representative makes decisions about a property on behalf of someone holding an interest in that property. Although many property contracts have the potential for abuse of agency powers, it is only in recent years that there have been attempts to establish the extent to which these agency costs may influence transactions.

This paper describes several common ways in which agency or quasi-agency relationships arise in real estate activities, such as funds management, property management, real estate brokerage and granting leases. The paper explains how monitoring and bonding costs, as well as increased uncertainty, in agency-like arrangements may distort property transactions and how changing the basis of the contract may lower the costs for both parties.

Several approaches to testing for agency costs are distinguished and the inadequacies of each approach are pointed out, illustrating how difficult it is to confirm the agency effects on property transactions. The paper reviews published empirical studies of the effects of agency costs upon the decisions to buy, sell or lease properties. Agency issues imply lack of trust and even dishonesty amongst those entering contracts. It is therefore not surprising that it is difficult to prove and quantify the agency costs. The paper concludes with some suggested tests of agency costs in property transactions, particularly in leasing.

Testing for Agency Costs in Property Transactions

Patrick Rowland

Part 1: Introduction

There has been growing curiosity about the potential effects of agency costs upon a wide range of transactions, including financial contracts and property exchanges. The term “agency costs” has taken on a broad meaning in the economics and finance literature, not limited to the legal relationship of agency. Agency costs arise from the uncertainty associated with the delegation of decisions. They may arise on any occasion when one party (the “principal”) relies upon but cannot entirely control the actions of another (the “agent”). Agency costs presuppose, first, a potential conflict of interest between the principal and agent and, secondly, that the agent has a better understanding than the principal (the latter is termed “information asymmetry”; Hirshleifer and Riley, 1992: 295).

The economic theory of principal and agent has been applied to managers acting on behalf of shareholders, farm managers acting upon behalf of absentee owners, employees acting on behalf of employers and consultants giving advice. Sometimes, the agency relationship is less explicit, such as the way that insurers are affected by the behaviour of those holding insurance or in sharecropping contracts. In these broader applications of the theory of principal and agent, there is often overlap with phenomena described as externalities, incentive problems, moral hazard and adverse selection.¹ In most cases, agency costs impose burdens on both parties to a contract, lowering the total benefits of the transaction.² The main reason for studying the agency costs is to find ways of modifying the contract to reduce the incentive for the agent to take actions that are not in the best interests of the principal.

Agency costs may be manifest in several related ways. Although Clauretje and Sirmans (1996: 42) state that “agency costs are incurred by the principal to minimize activity on the part of the agent that serves the latter’s interest at the expense of the former”, agency costs may also be incurred by the agent in order to secure or retain a contract.

Jensen and Meckling (1976: 308), in describing the agency effects on corporate capital structure define three aspects. First, there are expenses for the principal in monitoring the

¹ “Moral hazard” is the lack of care taken by someone who is insulated against the consequences, the most common example being the failure by an insured person to make efforts to avoid damage which will be fully covered by insurance. “Adverse selection” is the way in which the worst offending agents come to be the only providers of the good or service, as a fear of agency problems may lead the principal to lower the agents’ rewards. Those agents who do not intend to abuse their privileged position are driven from the market.

² Economists would refer to the total benefits as the combined consumer’s and producer’s surplus and agency costs reduce either one or both of these.

activities of the agent. Secondly, the agent may be obliged to give assurances, guarantees or other signals of good faith (referred to as “bonding costs”). Thirdly, there may be losses for the principal which monitoring and assurances do not avoid. These residual losses (which will be uncertain when the contract is signed) are the reduced utility of the principal arising from the actions of the agent. Monitoring and bonding costs will be incurred only if they will reduce the likelihood of losses for the principal.

If agents are prepared to accept a lower commission or other payment for their services because the principals are nervous about the agents’ reliability, this would also appear to be an agency cost. In fact, it is possible that competition amongst agents might result in a level of charges that results in the agents bearing all the agency costs.

In property markets, agency costs may be incurred when a manager, agent or other representative makes decisions about a property on behalf of someone holding an interest in that property. Part 2 of this paper describes several common ways in which agency or quasi-agency relationships arise in real estate activities, such as funds management, property management, real estate brokerage and shared interests in one property. The paper explains how monitoring and bonding costs, as well as increased uncertainty, in agency-like arrangements may distort property transactions and how changing the basis of the contract may lower the costs for both parties.

Although many property contracts have the potential for abuse of agency powers, it is only in recent years that there have been attempts to establish the extent to which these agency costs may influence transactions. Part 3 reviews the two common approaches to proving the existence of agency costs, being algebraic proofs and empirical testing. Part 4 explains why each approach to proving a concept as sensitive and many-faceted as agency costs has shortcomings. Part 5 suggests several alternative methods of testing for agency costs. Although these alternative tests may be helpful in some instances, there appears to be no panacea.

Part 2: Common agency issues in property transactions

There are many ways in which agency costs may arise in property dealings. Seven classes of potential abuses of agency or quasi-agency arrangements are described here, with some illustrations of the effects of changing contractual terms. The later parts of this paper look at attempts to confirm whether or not these potential agency costs are significant.

Managers of institutional property funds (such as insurance funds, superannuation funds, property trusts and other managed funds) act on behalf of their investors. Depending upon the fee structure, the managers may have their own objectives that are not compatible with the investors.³ The common Australian practice of paying property

³ There have been many studies of this phenomenon amongst corporate managers whose objectives may differ from those of their shareholders and debt-holders (for a review of these, see for example Peirson et al., 1995: 316) and studies of the corporate governance problems of the early Real Estate Investment Trusts in the USA (reviewed in Sirmans, 1997).

trust and some other managers a percentage of the funds under management is likely to encourage concentration upon expanding the fund rather than maximising their rate of return for the investors. There may also be incentives for the managers to smooth the periodic rate of return (to signal stability) or to maximise the current distributions to investors at the expense of prudent refurbishment of properties.

Managing agents responsible for running properties may act in a manner that enhances their fees at the expense of the building owner. Rosenberg and Corgel (1990: 186) point out the potential conflict of interest between landlords and managing agents when the fee is based upon gross rental collections, rather than on net income. With most property management contracts in Australia based upon gross collections, agents may concentrate less upon increasing net income than the gross amounts collected from tenants. The immediate consequence of increased operating costs is a higher management fee, although eventually this may lower the net rent that the tenants are willing to pay. Most management contracts can be revoked at short notice and this may give the managers little incentive to plan long term strategies to make buildings more attractive to future tenants.⁴

Real estate brokerage creates potential for a divergence between the interests of the agent and the principal, whatever commission structure is used (Yavas, 1994: 173). The principal often cannot observe the effort exerted by the agent who may prefer to curtail the search for a buyer at a higher price in order to receive a fee sooner. The usual basis of commission for selling property in Australia is a percentage of the selling price, with a declining percentage at higher prices. Although the commission gives the agent an incentive to sell for the highest price and as soon as possible (both of which suit the principal/vendor), the agent is more likely to concentrate upon a quick sale than the highest price (as to delay a sale to obtain a marginally higher fee may not justify the extra time and effort).

In *developing a building for sale*, the developer becomes an “agent” for any purchasers prior to completion of construction, as the developer has contracted to build for the purchaser. Moral hazard is thought to explain why building defects occur more frequently if a development has been sold before construction is completed. After the building has been sold, the developer has less incentive to achieve high standards, knowing that defects clauses are often difficult to enforce (Ong, 1997: 37).

In other transactions, agency issues may arise because two or more parties have stakes in the same property. If the actions of one party may be disguised from other parties whose interests in the same property may be adversely affected, this relationship can be modelled as that of principal and agent.

There are the potential conflicts of interest between the holders of the *debt and equity in a property* and the parties may guard against each others’ actions. This may be observed

⁴ A recent Exposure Draft issued by Australian Institute of Valuers and Land Economists describes the assessment of a property’s overall performance as an “additional service” (p.2) for which a separate fee would be negotiated.

in the contractual limitations placed on borrowers by lenders. The lenders are nervous that the owners may take undue risks or make decisions to enhance the value of their equity, lowering the value of the debt. As a result, agency problems may influence capital structure (Barnea et al., 1981: 7; Williamson, 1988: 567).

Secondly, this can also be observed in the relationship between *landlords and tenants*, each of whose legal interests may be damaged by the actions of the other party to the lease. Either the landlord or the tenant may operate the property and they seek to protect the reversion and the benefits of occupation respectively, whilst complying with their contractual obligations to the other party.⁵ Leases are contracts under which landlords and tenants rely upon the other party to protect each others' interests in the property. As such, various aspects of leases can be modelled as a principal and agent relationship.

Miceli and Sirmans (1995: 356) style the landlord of a shopping centre as a "common agent" for a group of principals, being the tenants. Although the leases enable the landlord to encourage behaviour in each tenant which increases trading volumes for all the stores, the landlord may also act opportunistically in enhancing his net income or the residual value. This opportunistic behaviour may occur whenever the tenant cannot fully monitor the landlord's expenditure or actions.⁶ As a further example, Lee (1995: 731) observed that a provision for turnover rent in a retail lease reduces agency costs because it gives landlords an incentive to manage shopping centres in such a way that maximises their tenants' turnover.

Smith and Wakeman (1985: 903) consider how lease provisions may alter the agency costs. They cite the use of service leases (in which the lessor provides the maintenance) as one way of avoiding the lessee's tendency to undermaintain the asset. A tenant (under a gross lease) can increase the need for maintenance by abuse of the premises which the landlord may be unable to detect (Benjamin et al., 1995: 177). Landlords aware of likely abuses of the premises by tenants will increase their required rent by enough to cover the undetected damage that tenants may cause (Miceli, 1989: 409). Occupiers who would not abuse their premises will consider the rent to be excessive and will prefer either to buy or find ways of leasing in such a way that their good behaviour can be observed. Only those tenants who intend to abuse the premises will consider that the rent proposed by the landlord is reasonable. This "adverse selection" results in tenants that are likely to abuse or neglect the premises, unless a lease structure can be devised which enables the landlord to control the tenant's usage.

Thirdly, *shared occupation of a property* (either as owners or tenants) creates externalities that can be modelled as agency costs (in the sense that the occupants agree

⁵ This framework has been proposed in Rowland (1995b) as a way of modelling the allocation of property responsibilities between landlords and tenants.

⁶ Such an agency problem can be seen in the current complaints by shopping centre tenants that they have no control over the centre management despite being required to reimburse the landlord for the full costs (the landlord is a quasi-agent for the tenants). As audit costs grow, gross leases are being seen by some landlords as a way of reducing the agency cost. However, this may remove an incentive for tenants to take care of the premises, a different form of agency cost (see the next paragraph).

to respect each others' rights and to share the costs of providing communal services). de Geest (1992: 300) considers the provision of communal services in a shared-occupancy building as a form of "public good" for the occupants. He describes how costs and control are shared to minimise exploitation of the public good. He concentrates upon the conflicts that may arise between the occupants or the owners in a condominium or strata title complex and how different contractual forms may accentuate the conflicts, which are a form of agency cost.

Although there has been much speculation that agency issues such as these may influence property contracts, prices and rents, the proponents of agency theory have found it difficult to prove that these costs have a significant impact. The agent or quasi-agent in each case will deny taking advantage of any superior knowledge, giving such reasons as professionalism and the benefits of a impartial reputation. Part 3 of this paper describes recent attempts to confirm that agency costs influence real estate markets.

Part 3: Recent attempts to confirm the existence and magnitude of agency costs in property transactions

3.1 Mathematical proofs

Early writings on agency costs resorted to algebraic models of the predicted behaviour of any principal and agent, given carefully specified assumptions.⁷ This theoretical literature explores the ways in which imperfect information and contractual terms can be utilised to give the agent the greatest incentive to minimise the agency costs. Algebraic models have devised optimal rules for sharing the output (and the risk), based upon stochastic inputs and the agent's effort, which it is assumed cannot be monitored by the principal (see, for example, Holmstrom, 1979: 77 and Rees, 1985: 3). The universal basis of these models is that agents seek to maximise their own welfare.

This approach to proving the existence of agency costs has been adopted in several papers that explore which type of listing will encourage the most effort by a real estate agent to sell a property for the highest price. Geltner et al. (1991: 6) confirm that "the broker's profit-maximizing level of selling effort will tend to be too small from the seller's perspective". Arnold (1992: 100) demonstrates how a fixed percentage commission should minimise agency costs. Miceli (1991: 548) considers in a two stage model (securing a listing and then searching for a buyer) the optimal split of commission between listing and selling agents.

Several papers have addressed the agency costs or incentive problems in housing leases. The widely quoted paper by Henderson and Ioannides (1983: 99) describes the difficulties of forcing tenants to carry out all the repairs that an owner-occupier would deem necessary. Their two period model assumes that the maintenance costs in the second period are some function of the intensity with which the housing is used in the

⁷ Jensen (1983: 334) provides a concise distinction between two agency literatures - one which simplifies the contracting problem in an algebraic but non-empirical manner and the other which is more descriptive but more amenable to empirical testing.

first period. The tendency for tenants to overutilise premises is shown in equations to be a consequence of the lack of control over the tenant (which the authors refer to as an “externality”).

Similarly, Benjamin et al. (1995: 181) demonstrate in an algebraic model that the tenant’s inclination to overuse and/or undermaintain leased premises (which they refer to as an “incentive problem”) imposes a cost, initially on the landlord, that would be expected to “cause the market for leased space to fail”. The tenant has no interest in preserving the residual value of the property and this agency cost does not exist for owner-occupied properties. The authors then describe various ways in which leases might be amended to lessen or remove the effects of the tenant’s incentive to abuse the premises, such as contracts obliging the landlord to maintain, giving the tenant an option to buy, requiring security deposits or adjusting the rent according to the intensity of use (Benjamin et al., 1995: 184).

3.2 Empirical confirmation

As more sources of objective secondary property data have become available, much real estate research has turned to statistical proofs and there are a few examples of tests of the influence of agents upon property transactions. In some cases, this has been as an extension of the algebraic models of agency costs described above but it is often as a test of a reasoned hypothesis or an observed phenomenon.

Portfolio and property management

Solt and Miller (1985: 407) recognised the potential moral hazard problem in Real Estate Investment Trusts (REITs) that arose from the superior information held by their managers. The empirical analysis of Solt and Miller (1985: 416) suggested a significant relationship between the fee structure and the financial performance of the trust, indicating an agency problem. During the later years of their study, this problem was being addressed by changes to the reward structure of REIT managers (it was becoming common for REIT managers in the USA received incentive fees).

The tests carried out by Hamill (1993: 133) confirmed that the fee structure (front end fees versus a profit share) in limited partnerships differed with the complexity and risk of the public offering and with the reputation of the general partner (as judged by years in the business). This offers some indirect support of agency theory as the general partner appeared to vary fee structure to reflect the need to signal confidence in the offering.

Graff and Webb (1997: 19) use disaggregated data for institutional property returns (from NCREIF) to test whether portfolio managers are influenced by the incentive in their fee structure to overpay for acquisitions. They conclude that this agency cost may explain the serial correlation in property returns that would not exist in a weak-form efficient market (if the manager overpays, valuations are likely to start at the price paid in an arm’s length transaction, even if it appears high, and move towards a “fairer” price at each revaluation).

The study of agency costs in property management by Rosenberg and Corgel (1990: 194) showed that distancing managers from ownership resulted in significantly higher

operating costs for the apartment buildings in their survey. Lower operating costs were associated with properties owned by individuals or private partnerships.

Landlord and tenant relationships

Glascok et al. (1993: 74) test their algebraic model that owners who occupy part of an office building are likely to exert greater maintenance effort than absentee landlords. They attribute the higher rents in partially owner-occupied buildings to lower agency costs because potential tenants of buildings are less concerned about building neglect when the landlords are also occupants. Partial occupancy by landlords is a signal to tenants of a commitment (by landlords) to maintain. Their model demonstrates that the leased offices of resident landlords should attract higher (gross) rents than those of absentee landlords and the authors show this to be true in a sample of office buildings. However, Springer and Waller (1996) found no relationship between absentee ownership and the level of property maintenance in their survey of residential rental properties.

Part 4: Shortcomings of these tests of agency costs

In several ways, these tests of agency costs are of dubious value. Although some of the shortcomings described below might apply partially to any proofs in real estate economics, the nature of agency issues makes it particularly difficult to confirm their existence and to quantify their effects.

4.1 Proofs based upon algebraic models

Each algebraic model is founded upon a number of limiting assumptions. In the agency cost models, some of the assumptions that are necessary to draw meaningful conclusions are either unrealistic or overly prescriptive. For example, it is common to assume that the agent and principal have different attitudes to risk, with one being risk neutral or risk averse and the other being a risk-taker. There is little basis upon which to generalise about the attitudes to risk of a group of agents or principals but often the mathematical proof of an optimum contract or incentive structure relies upon this.

Although there has been much speculation that agency issues may influence property contracts, prices and rents, the proponents of agency theory rarely acknowledge that the agents or quasi-agents that have been mentioned above operate in markets in which trust, good faith and professionalism generate further business. As such, the inclination to take advantage of asymmetrical information in one transaction is countered by the longer term benefits for the agent of enhancing their reputations. This is difficult to build into formal models of the behaviour of agents. Mathematical models of agency costs consider isolated transactions to avoid the undue complexity of incorporating such issues as subsequent dealings and the agents' reluctance to harm their reputations.

Many attempts to demonstrate the existence of agency costs have recognised that other accompanying factors may favour the opposite outcome to the agency costs. This is evident in many attempts to explain prevailing lease structures. For example, Williams (1993: 89) suggested that economies of scale and agency costs are conflicting factors in the choice of housing tenure (with the economies of scale in maintenance encouraging

leasing in large complexes and the difficulty of enforcing maintenance clauses encouraging owner-occupation of small complexes and single family homes). Wolfson (1985: 168) anticipates a trade-off between the minimisation of agency costs and the tax advantages of leasing (when owners and lessees have different marginal tax rates). Lee (1995: 734) observed that, in retail leases, risk-sharing and agency costs may lead to leases which combine a base rent and a percentage rent (payable over a turnover threshold).

In some cases, it appears that the assumed motivation and predicted behaviour of agents are little more than wild speculation. For some applications, it is unimportant what the source of the agency cost is. In which case, it is sufficient to prove that the agent raises the costs of contracting. However, many algebraic models will suggest different outcomes if the agency cost arises from different motivation of the agent. For example, when applied to real estate and corporate management, some agency models are built around managers seeking to maximise their income. Other models are predicated upon a manager whose first objective is preserving their employment. The effects on the principal and their property transactions are quite different, depending upon the agents' objectives.

Similarly, the assumption in the leasing literature that an agency cost arises from the difficulty of monitoring the tenant's lack of maintenance has been questioned. Kanemoto (1990: 7) believes that the lack of control over the tenant should be ascribed to the difficulty of "third party verifiability", rather than the difficulty of observing the tenant's actions. Kanemoto argues that the real difficulty is wording a lease contract with sufficient precision that the landlord can prove to a third party (such as a court) that the tenant is guilty of lack of care or overuse of the premises; "specifying housing investment in a rental contract is particularly costly" (Kanemoto, 1990: 10). To confirm whether there are agency costs (moral hazard) in the maintenance provisions in leases, it may be necessary to distinguish monitoring from enforcement costs.

This form of abstract analysis does give some insights and may suggest the direction in which agency effects drive transactions. However, mathematical models of agency costs rarely allow the severity of the problem of conflict of interest to be assessed (Geltner et al., 1991: 8). This can better be attempted by statistical analysis.

4.2 Empirical confirmation

The conclusions from empirical testing of the existence and scale of agency costs are weakened by several difficulties. The most serious problem is probably isolating the effects of agency costs from other variables that affect the transactions. Since agency costs arise from the ability of agents to hide information and hide their actions from their principals, it is rarely possible to observe them directly. Instead, tests for agency costs try to show that the transaction prices or transaction costs are different when there is *potential* for the agent to exploit the principal. This potential for exploitation may be closely associated with differences in such factors as the motivation for purchasing, the type of properties, the governance under which the manager operates or the type of lease structure.

For example, one might compare the reward system for property trust managers with the reward system for superannuation fund managers to see whether the net returns from properties owned by each group are significantly different. However, to conclude that agency costs cause any difference is to ignore, amongst other things, the differences in the time horizons for their investment and the differing risk aversion of their investors.

Similarly, buildings owned by institutions may be more expensive to run than those in private ownership because the institutions cannot easily observe the efforts by the manager. However, they may be more expensive to run for a number of other reasons, such as the institutions' preference for prime buildings or their willingness to spend to combat obsolescence. Rosenberg and Corgel (1990: 198) observed a high degree of multicollinearity in their regression models of apartment operating costs.

As a further example, a statistical proof that office buildings partly occupied by their owners are likely to attract higher rents than those fully tenanted might be considered to be an indirect proof of agency costs. However, the difference in rents may be attributed to other causes which are correlated with the occupation of owners. The partial owner-occupier may prefer buildings with superior exposure or with additional services or may be leasing small areas on short-leases, all of which might explain higher rents than fully tenanted buildings. It may be difficult to isolate the effects of these correlated variables from the suspected agency costs.

The second common problem in empirical testing is that there is often only one corporate governance, one basis of rewarding management, one brokerage fee system or one lease structure that is adopted in any market. This might suggest that the market has settled on the most effective compromise between agency costs and other contractual requirements such as appropriate risk allocation mechanisms and the benefits of specialisation (or economies of scale). However, it makes it almost impossible to test reliably for agency costs as there are no opportunities to compare contractual arrangements with different potentials for exploitation by agents or managers.

A third difficulty with empirical tests of agency costs is that it very often requires data on individual transactions to detect whether the behaviour of the agent or manager alters market outcomes. In most cases, details of individual transactions are not available or would only be available from the agent or manager who may be reluctant to reveal details and the background to transactions.

Some demonstrations of agency costs require the assumption of market efficiency, except for the inefficiency created by the presence of the agent or manager with superior knowledge (such as in the study of "persistence" in historic returns data by Graff and Webb, 1997: 22). This implies that the inefficiency is created solely by the agents, whereas several other equally plausible reasons for inefficiency have been suggested elsewhere (reasons connected with data shortcomings and valuation smoothing). Although a pattern of inefficiency may be revealed which is consistent with, for example, fund managers' overpaying for properties to enhance their fees, there would appear to be several other explanations of the inefficiency.

A fourth difficulty is that, agency costs may be revealed in several aspects of the transaction. As pointed out in Part 1 above, the perception that an agent may take advantage of superior knowledge may result in monitoring costs by the principal, bonding costs by the agent or a residual loss. Most of the empirical tests have concentrated upon confirmation that the residual loss lowers the value of the stakes in managed funds, in the properties or in the shared interests in the properties. It is suggested below that, amongst other approaches, quantifying the monitoring and bonding costs is as important as quantifying the residual effects on the value of the assets.

Part 5: Suggested alternatives for testing for agency costs

The following alternatives are suggested as methods of proving to reasonable satisfaction that agency costs influence transactions in specific property markets. One or more may be appropriate in analysing the actions of fund or property managers, others for real estate brokers and others for lease structures. In this paper, all the suggested tests are illustrated below with examples that relate to the agency problem believed to exist in leases.

5.1 Direct surveys of principals and agents

Agency costs are relevant whenever principals believe that their interests may not be entirely served by their agents, *even if* the agents have not been taking advantage of superior information or hiding improper actions. The perception can be as important as the actual disadvantage suffered by the principal. Hence, direct questioning of principals and agents may have the advantage (over empirical testing of the effects on prices) that the perceptions of each can be contrasted. Although agents are highly unlikely to reveal whether they are not acting in the best interests of their principals (and in some cases, they would be liable for legal action if they did), they may be willing to discuss the lengths to which they go to assure their principals of good faith (“bonding costs”).

Principals may find it difficult to answer how much their suspicions of agents influence their pricing decisions, but there is no reason why confidential surveys of principals could not be attempted. However, this generally requires some hypothetical questions (such as “if you did not need to rely upon an agent, how much more would you bid ?”) and there are doubts that hypothetical answers in surveys reflect actual behaviour.⁸ Such surveys are also expensive and time-consuming.

In the case of leases, surveys could be used to clarify such issues as the current concerns of Australian retail tenants that they may be reimbursing landlords more than the reasonable cost of operating shopping centres. This is evidently a contentious issue (see Commonwealth of Australia, 1997: 59) and the survey results might gauge the strength of feeling of a representative sample of tenants.

⁸ A mailed survey of landlords and tenants (Rowland, 1995a) was only moderately successful in revealing their willingness to switch between gross and net leases, revealing whether a preference for control over operating expenses influenced rents. The survey used hypothetical questions which some of the respondents appeared to find difficult to grasp.

5.2 Experimental tests

Behavioural experiments have been used in some fields of economics, in particular, the economics of uncertainty and bargaining games. It might be possible to conduct controlled experiments of principals and agents under defined scenarios.⁹ A number of people with experience of leasing properties might be asked to consider a variety of lease structures which alter the potential for agency effects and alter their rental bids. These experiments are somewhat like the hypothetical questions proposed (see 5.1 above) as there are doubts whether the players of the games would follow the same course in reality as in the game.

5.3 Investigation of case studies

Because agency arrangements are invariably complex to analyse, they are not always amenable to a statistical treatment. An alternative is to research a few cases in full detail. This form of qualitative analysis, although frowned upon in many fields, may be a way to get to the heart of the motivation of parties contracting for services and relying upon the expertise of others. To obtain a better understanding of the quasi-agency issues in landlord and tenant relationships, interviews with a group of landlords and a group of tenants might be followed by sessions in which landlords and tenants are brought together to explain how they concluded their lease agreements. These kinds of case studies can be criticised as likely to be unrepresentative. The parties may be reluctant to participate in discussions about agents' activities as it may prejudice their later relationships. They would also need to have absolute confidence that no breach of confidentiality could occur.

5.4 Quantifying monitoring and bonding costs

It has been pointed out (see 4.2 above) that many of the test of agency costs concentrate upon the residual loss only. It would be possible, either in conjunction with a direct survey or a case study, to measure the monitoring and bonding costs that the principal and agent respectively incur. In the context of leases, these would be the time spent checking that tenants (and landlords) are complying with lease covenants, the administration and opportunity costs of tenants' bonds, the audited statements of operating costs provided by landlords to recharge expenses to tenants and the costs of any enforcement action by either party. Any lease structure that can avoid the need for these efforts results in savings for either landlords or tenants or both, although it is not clear whether it would increase or decrease rents.

Some of the agency costs may be borne by agents competing to secure contracts. Thus, instead of looking for the residual effect of agency upon the transaction, some or even all may be found in the acceptance by the agents of a lower commission, salary or other payment for services. If competition amongst agents results in them bearing a significant portion of the residual agency costs, another form of testing is required. These might be empirical tests that investigate whether contractual conditions that lower the potential for abuse by the agent result in higher commissions. In the relationship between landlords and tenants, this might be observed in the willingness of

⁹ Yavas et al. (1997) have conducted such an experiment by introducing an agent into a bargaining game between buyers and sellers of houses.

tenants to pay a higher gross rent than the net rent plus the expected operating costs.¹⁰

Part 6: Conclusion

It is evident that agency costs are difficult to confirm and even more difficult to quantify. In 1983, it was suggested that agency theory was perhaps too poorly developed to move to mathematical testing of hypotheses (Jensen, 1983: 335) and it may be the same is still true. However, to suggest that agency costs exist is an implied criticism of many real estate professionals and it would be in their interests to be able to refute allegations of abuse and, in the longer term, to design contracts that lessen or remove the potential for agency problems to arise. It is hoped that, by measuring agency costs, improved contractual arrangements will be designed which reduce the incentive for agents to take actions that are not in the best interests of their principals. Testing for agency costs would appear to be a worthwhile exercise but not one for which any obvious methods are available.

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¹⁰ This result might also be explained by the preference of risk-averse tenants for the certainty of gross rents, rather than agreeing to reimburse the landlord for unknown operating expenses. Again, there is a difficulty in isolating this from the agency effects.

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