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Market failures and costs of intermediation cause obstacles to the delivery of transactions: A critical discussion on the impact of information asymmetries and conflicts of interest on contractual relationships

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Abstract--To understand economic growth, this paper looks at transaction costs and how they affect how much money people make. It shows transaction costs, market failure, and economic underdevelopment. Many people think that the problems with development are because markets can't do their job of allocating resources. Some people don't believe that the market doesn't work and blame the government instead. If you look at the people who say that market failure is the root of economic backwardness, very few, if any, look at transaction costs and how they are linked to market failure. People who read this paper want to connect development economics with transaction cost theory and new institutional analysis.

Keywords--Market failure, economic development, market power, opportunism, economic development.

Introduction

Market failure can be defined as the insufficient supply and distribution of goods and services relative to the demand in a market[1]. On the other side, costs of intermediation are direct and indirect costs, losses or revenue decrease that may result from using a third party – which is delegated to act on one's or an organisation's behalf – in investment or financial decisions and transactions[2].

This paper will outline two sections. The first section will find out how the market failures and costs of intermediation cause obstacles to the delivery of transactions by reviewing a number of studies on this subject. The second part of section one will incorporate the economic theories of moral hazard and adverse selection in assessing the impact of information asymmetry and conflicts of interest on contractual relationships. The second section will explore the principal-agent and

positivist approaches of agency theories in explaining how the adverse selection and moral hazard cause obstacles to transactions delivery.

Section One

Market failure

Firstly, this section focuses on the ways in which market failure causes an obstacle to the delivery of the transaction. Some scholars think that market failure in terms of market equilibrium is a situation in which the goods and services produced and distributed in the market do not meet or equate the demand in the market [3]. The supporters of this view believe that the demand and supply control the market, thus when the demand is higher than the supply then the market fails. Other scholars view market failure in terms of the Pareto-optimality as the failure of an idealised price- market institution to stop “undesirable” activities or sustain “desirable” activities whereby activities refer to production and consumption [4]. The supporters of Pareto- optimality believe that market works optimally when there are no changes in the market can increase the welfare of one player without damaging the welfare of other players in the market. Other scholars view market failures in terms of lack of government intervention which gives the players in the market the freedom and autonomy to control their transaction costs and price systems [5]. The proponents of this view believe that government regulation helps to keep the players under the observation in view to make a perfect competition in the market. However, markets cannot compete perfectly because of the existence of monopoly in every market. Moreover, monopoly in a market leads to distortion of prices and information asymmetry and that leads to market failure [6]. This paper finds out that market failure results from inefficiencies in production or allocation of resources. Inefficiencies in production and resource allocation are caused by externalities and asymmetric information in the market [7].

Externality

An externality can be defined as activities or actions of one of the producers in the market that affects the producers in the market without reflecting in the price system [8]. In other words, externality happens when production or consumption of a good or service affects a third party who is not directly involved in the production or consumption of that good or service. Externalities can be negative or positive.

Positive externality yields benefits to the third parties, whereas negative externality yields distresses to the third parties. Negative externality affects the market equilibrium by interfering with the market price system as the price system fails to reflect the actual value of goods and services [9]. Therefore, resources in the market are inefficiently allocated interfering with the production and consumption of goods or services, which is an obstacle to the delivery of transactions. As mentioned above, inefficient resource allocation means resources such as capital, land, and labour are not easily available in the market. As result, this essay finds that externality arises when the action of one or more of the producers in the market yields uncompensated real economic implications on

other producers in the market [10]. For instance, the missions that come from one of the producers in the environment pollute the environment, which may affect other players in the market through government restrictions and price-tax conditions. Thus, other players may have no control the actions of the emitter, but at the end, they must pay the price for environmental pollution, which affects their delivery of transactions. Externalities are more pronounced in non-regulated markets as the actions of the producers are not moderated by the government [11]. It implies that in free markets, other producers pay a greater price for actions of one of the producers which significantly obstruct their delivery of transactions. Therefore, government regulation through taxes, subsidies, and property rights are necessary in reducing the impact of externalities [12].

Information asymmetry

It will be explored how asymmetric information affect and cause an obstacle to the delivery of transactions in the market. Information asymmetry happens when the level of information or knowledge on the details of good or service involved in a transaction differs between the parties involved [13]. Asymmetric information in the market affects the production, distribution, and consumption patterns in a market [14]. In addition, information asymmetry leads to inefficiencies in resource allocation. This means the various market producers have different information on the resources and, thus, they use this information to make production and distribution decisions and efficiently access resources. The players who lack this information are disadvantaged and are forced to change their prices or get out of the market¹⁷. When the price system cannot sufficiently reflect the value of goods and services in the market, inefficiencies in resource allocation players are disproportionately affected, finding it difficult to survive in the market-leading to monopoly [15]. Monopoly may be an obstacle to the delivery of transaction as it distorts market prices and information. Asymmetric information in a market may be costly for sellers with better qualities as they may have to incur the cost of waiting for all the goods of bad quality to be traded before they can trade [16]. Thus, due to asymmetric information in the market the consumers are not able to differentiate between the good quality and low-quality goods or services. As a result, the sellers with good quality goods are forced to sell at the same price as the sellers with low-quality goods, services or have to wait for the sellers with low quality to sell all their goods.

Cost of intermediation

This part focuses in the ways in which the cost of intermediation cause an obstacle to the delivery of transactions. Intermediaries act as representatives or middlemen between two parties who involve in a financial transaction, for example, commercial banks, agents, dealers, and brokers [17]. Financial intermediaries such as commercial banks offer banking services, investment information and loans to their clients, whereas insurance providers offer security to their clients against various Risks [18]. The intermediaries' services are important in the market because without intermediaries the probability of a successful trade significantly decreases as well as intermediary helps the buyers and sellers to match each other [19]. The intermediaries increase client confidence in transactions, as the clients believe that intermediaries provide

reliable information. Therefore, they convince the buyer that the deal is worth it and that they need to sell for the amount proposed amount [20]. Some forms of financial intermediation help to reduce the cost of accessing information and at the same time, it helps to reduce the cost of negotiating contracts and transactions [21]. For instance, market maker like the New York Stock Exchange creates a market place for potential buyers and sellers for exchange, reducing the cost of locating potential buyers or sellers. Nonetheless, for other forms of types of intermediaries such as banks and agents, the clients must bear costs such as bank services fees and cost of financial risk in investments to secure their services [22].

Cost of intermediation forms part of the total transaction cost which is born by the parties involved in a transaction; thus the cost of intermediation determine the transaction cost²⁷. This means that when parties in a transaction calculate the values that involved in a transaction, they must consider the amount of money that may be paid to the intermediaries involved such as agent fees, bank charges. As well, it means that when the cost of intermediation is high, the overall cost of the transaction also increases. In a free market, there is no government regulation on the cost of intermediation such as bank charges or interest rates and, thus, the intermediaries have all the control to determine costs of their services to clients [23]. For example, before the Kenyan government intervenes in the banking sector; the cost of loans was immensely high because the commercial banks had the whole control of setting their own interest rates [24]. As stated above, the high cost of intermediation means high transaction costs which may hamper the delivery of transactions.

Section Two

Contractual relationship

This essay defines a contractual relationship as a relationship between a client who is the principal and an agent in which the principal pays the agent to promote their interest [25]. However, this relationship may suffer from hidden information or hidden action what is known as adverse selection and moral hazard. Moral hazard happens when the representative who is the agent undertakes an action which is unobservable to the principal and has more value to the agent as compared to the principal [26]. On the other side, adverse selection happens when the agent has more information on the risk on which a contract is reached than the principal does. For instance, in the case of insurance, when the insured (the principal) has more information on the probability of an accident happening as compared to the insurer (the agent), then adverse selection has happened. Both adverse selection and moral hazard explain conflict of interest between the agent and principal resulting from information asymmetry and in which the less knowledgeable party is the end loser in the relationship [27-28]

Agency theory

This part looks at some of the theories which explain the conflict of interest in contractual relationships. The supporters of this theory have argued the theory in

two perspectives, namely; positivist agency theory and principal-agent agency theory[29].

The two perspectives address agency problems that arise from self-interested parties contracted to each other, and both assume that in all contractual relationships, the agency costs are minimised which mark their similarities³⁶. However, the positivist agency theory is mathematical and is mostly non-empirical, while the principal-agent approach is empirical and mostly not mathematical, which make these approaches opposite each other [30]. The positivist agency theory focuses on the conflict of interest that arise from the relationship between principals and agents in the corporate structure and governance[31]. According to the positivist agency theorists, the managers are the agents, whereas owners or shareholders are the principals within the corporate governance setup. The problem arises when the interests of the owners and the managers of a corporation are competing, which lead to conflict of interest.

Conflict of interest in corporate governance arises when the firm, its owners or management faces a situation where an action by or influence of any of the stakeholders has the potential to benefit personal or private interest[32]. Asymmetric information between the managers and the shareholders causes the conflict of interest between the principals and agents [33]. This conflict of interest has existed for decades since corporate governance appeared and it is predicted to continue to exist for a long time in most open corporations [34]. The problem is that the contractual relationship between the managers and the shareholders grants the managers the opportunity to control the corporate⁴³. This is evident in the description of agency relationship offered by Jensen and Meckling. They define agency relationship as an agreed contract in which the principals engage with an agent to perform given tasks on their behalf and which involves the principal allotting powers to the agent [35].

Delegation of decision-making power forms the genesis of the conflict of interest because the agents believe that they have the expertise to run the corporation even when the principals are not satisfied with it [36]. The view is supported by Fama, who found that separation of security ownership and control is an efficient system of economic organization in large corporations [37]. Fama explains that managers are contracted by the stakeholders who are the owners to make decisions and take control on their behalf, which in essence leaves the owners with indirect control over the organisation. The problem arises when the owners try to keep the managers responsive to their interest, while managers on the other side try to pursue what they think to be the best interest for the corporation [38].

The theory of the firm developed by Jensen and Meckling is one of the influential works in the positivist agency theory approach. The theory refers to a firm as a black box existing on the purpose of maximising the profits of the corporate [39]. Jensen and Meckling claim that when the manager and owner work as utility maximizers, then the manager will not always promote the best interest of the owner⁴⁹. As a result, the owner establishes mechanisms which entail incurring monitoring costs to minimise the manager's divergence from the owners's interest. Similarly, the owner may pay the managers for bonding costs to guarantee that the manager cannot hurt the interest of the owner or to compensate the owner in

case the managers take such an action [40]. The cost that may incur by the owner as a result of the manager's divergence from the owners's interest or in assuring the manager's realization of the owner's interest is known as the agency cost [41]. Jensen and Meckling claim that it is impossible for the owner to ensure that the manager acts in the owner's best interest at zero cost. Furthermore, they explain that there will always be divergences in the manager's and owner's interest. In other words, the theory of the firm confirms that the moral hazard and adverse selection will always happen in an agency relationship.

The second approach to agency theory is the principal-agent which explains the agency problems which exist in the agency relationships of an employer and employee, buyer and supplier, and lawyer and client, among others[42]. Armour, Hansmann, and Kraakman found that agency had three major problems. The first problem is the conflict of interest between the managers and the owners which has been explored in positivist agency theory. The second problem is the conflict of interest between the majority shareholders. The majority shareholders (owners) have the control, whereas the minority shareholders do not have control. In this case, the majority owners are the agents and the minority owners are the principal and the last group tries to ensure that they are not expropriated by the former. The problem arises when the minority owners have veto powers to make certain decisions which give them the power to try to make the majority owners respond to their interests[43]. The third problem is the conflict of interest between the firm itself and other parties the firm is contracted to, such as employees, customers, and creditors. The problem arises when it comes to guaranteeing that the agent does not take advantage of the principles such as exploiting the employees, misleading the customers, or expropriating the creditors. Nonetheless, the problem of ensuring that agents are responsive to the principals' interest is more pronounced where the principal is a large group of people and especially when they have different preferences[44]. This is because the high principals are many; they will be limited by coordination and information costs which hinder their ability to reach a collective action. When it is difficult to coordinate

among themselves for collective action, the principals may be forced to delegate more of their decision-making powers to the agents. Therefore, the principal-agent agency theory argues that the high number of principals leads to failure in coordination which causes an obstacle to collective action. This theory also argues that multiple principals mean high levels of information asymmetry, which leads to different preferences. Consequently, polarisation happens because of different groups pursuing different interests. Clearly, this gives the agents more decision-making power and increases their irresponsiveness to the interest of the principals[45]. In other words, moral hazard increases in the relationship where the principals are many and divided in opinions meaning that many principals form a barrier to the determination to increasing the agents' responsiveness.

In conclusion, this essay has found that market failure and cost of intermediation are obstacles to the delivery of transaction through asymmetric information and externalities in the market. Both asymmetric information and externalities interfere with the market equilibrium, Pareto-optimality, production, distribution, and consumption patterns in the market. As a result of asymmetric information and externalities in the market, inefficiencies in resource allocation are inevitable

and as a result some the players in the market are disadvantaged which forces them out of the market leading to monopoly. Inefficiencies in the resource allocation affect the production of goods and services which consequently hamper the exchange of goods and services between buyers and sellers in the market.

Conclusion

This essay has also found three agency problems that can cause obstacles to the delivery of transactions. The first one is the conflict of interest in the agency relationship between managers and owners of corporations. The problem arises when managers pursue interest rather than promoting the interest of the owners. The second problem is the conflict of interest between employers and employees, suppliers and firms, and lawyers and clients, among others. The problem comes when the agent promotes personal interest rather than the interest of the principal. The third problem is the conflict of interest between majority owners and the minority owners of the corporation. The problem arises when the majority owners try to expropriate the minority owners out of control of the corporation. The three problems are barriers to delivery of transactions as explained in section two.

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