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# Market transaction costs of corporate management

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The paper deals with studying of transaction costs of the corporate management arising as a result of conflict of interests between principals and agents, minority and majority shareholders, shareholders and creditors, managers and creditors, companies and community. Mechanisms of conversion of benefits of certain entities, not provided by agreements, into transaction costs of other corporate management entities are considered and represented by diagrams.

**Key words:** transaction costs, principals, agents, creditors, financial leverage, opportunism, venture projects.

**Маляр Д.В., Карлова А. РИНКОВІ ТРАНСАКЦІЙНІ ВИТРАТИ КОРПОРАТИВНОГО УПРАВЛІННЯ**

Стаття присвячена вивченню трансакційних витрат корпоративного управління, які виникають внаслідок конфлікту інтересів між принципалами та агентами, між міноритарними та мажоритарними акціонерами, між акціонерами і кредиторами, між менеджерами і кредиторами, між компаніями та суспільством. Розглянуті та зображені графічно механізми перетворення непередбачених угодами вигід одних суб’єктів в трансакційні витрати інших суб’єктів корпоративного управління.

**Ключові слова:** трансакційні витрати, принципали, агенти, кредитори, фінансовий важіль, опортунізм, венчурні проекти.

**Маляр Д.В., Карлова А. РЫНОЧНЫЕ ТРАНСАКЦИОННЫЕ ЗАТРАТЫ КОРПОРАТИВНОГО УПРАВЛЕНИЯ**

Статья посвящена изучению трансакционных издержек корпоративного управления, которые возникают в результате конфликта интересов между принципалами и агентами, между миноритарными и мажоритарными акционерами, между акционерами и кредиторами, между менеджерами и кредиторами, между компаниями и обществом. Рассмотрены и представлены графически механизмы преобразования непредвиденных соглашениями выгод одних субъектов в трансакционные издержки других субъектов корпоративного управления.

**Ключевые слова:** трансакционные издержки, принципалы, агенты, кредиторы, финансовый рычаг, оппортунизм, венчурные проекты.

**Problem statement.** Corporate management is an essential basis of creation and functioning of joint-stock companies, the most popular form of organization of big business in Ukraine and in the world. Corporatization is a mechanism of raising funds which allows accumulating significant financial and material resources necessary for technology-intensive production [1]. At the same time, joint-stock business pattern is connected with a number of problems and conflicts of corporate management, which cause the increase in transaction costs. This range of problems is rather urgent and ambitious; they are investigated within relatively new field of the economic science – neo-institutionalism.

**Analysis of recent studies and publications.** Below mentioned scientists are rightfully considered the honored founders of the theory of transaction costs: A. Berle, M. Jensen, J. Commons, R. Coase, W. Meckling, J.Mintz, D. North, O. Williamson.In spite of short term of development of business sector in Ukraine, significant contribution into genesis of the modern theory of transaction costs was made by domestic scientists, such as:S. Arkhiereiev, I. Buleiev, N. Ivanov, G. Kireitsev, M. Кovalenko, V. Kuzmenko, G. Makukhin, V. Myloshik, A. Oleinik, A. Shastitko.

**Identification of unsolved aspects of the generic issue.** For the most part the works of scientists deal with intra-company transaction costs of the corporate management, however so-called market costs or exogenous transaction costs arising from interaction with the external environment representatives (governmental agencies, community and creditors) are no less important.

**Formulation of paper objectives.** Objectives of this paper consist in studying of the market costs or exogenous transaction costs of the corporate management, which can be achieved by fulfilling the tasks below: exploring the formation of company's transaction costs under the influence of stakeholders, transaction costs of the community under the influence of unresolved conflicts between corporate management entities, and transaction costs between shareholders and creditors.

**Main points of the study.** Transaction is a kind of operating activities which can bear between-subject and subject-object nature (for example, when any entity exerts influence on the work objects by technical means). Studying of the etymology of the term "transaction" allows identifying two components: *trans*– the state between something, or transition from one to another state, and *action*, i.e. activity. Therefore, transaction obligatorily reflects between-subject relations, i.e. its performance takes place between the donor and recipient (agent and counteragent), and includes a social component. Hence, transaction costs mean the costs of between-subject interaction though one or another reason. Under this approach, we distinguish intra-company and market transactions. In the first case, it is interaction between employees, managers, and shareholders within one and the same company, and in the second case it is interaction with the economic agents (suppliers, partners, competitors, customers, governmental agencies etc.).

Specific nature of the corporate management implies both cases, since the list of corporate management participants, apart from managers and shareholders, includes governmental agencies, and creditors (borrowers and bond holders) as well [2, c. 12]. Today there are many definitions of the corporate management; each of them displays a certain important aspect of such definition. For example, according to the approach of A. Shleifer and R. Vishny, corporate management is a set of methods and means by which suppliers of funds provide obtaining of the relevant return on their investments [3]. The fundamental principle of the corporate management is the relationship between principals (co-owners of the company - shareholders) and agents (managers) andin case of agreed and unidirectional relationship the required synergy is achieved, securing the best protection of investors' interests. Under this perspective, the first things to be studied in the framework of the corporate management are the mechanisms of reversibility and return on investments for the investors, instead of the issue connected with minimization of transaction costs. At the same time, suppliers of funds are creditors, and according to this definition they are subjects of corporate relations, however secondary ones, with less volume of rights or entirely different rights. Therefore, if the management is focused on actions of personnel, the corporate management is oriented towards the vector of behavior of the company as a whole which is determined by the influence of individual participants of corporate relations.

According to the theory of associates and stakeholder–agency theory of Ch. Hill and T. Jones, growing dependence of companies on the external environment [4] is taken into account. It is shown by the greater accountability of the companies to the will of other entities except shareholders and managers, that is, ordinary employees, suppliers, consumers, public organizations and so on. In other words, de jure current management should meet the interests of investors (shareholders), while de facto the company is forced to be guided in its operations, one way or another, by the interests of other stakeholders as well representing the external environment (other than corporate management entities), but nevertheless having certain impact on management decisions of the company. This situation leads to additional costs of the company (and, accordingly, the costs of its shareholders and staff) which are imposed by third parties of the external environment. It is clearly demonstrated at the level of Anglo-American model of corporate management; corporations here are highly dependent on the legislation and conditions of activity of certain states, which issue direct orders to the companies' boards of directors with regard to taking into account the interests of the state economy as a whole, and social interests of the local population, instead of shareholder interests. Similar effect is observed on the part of public organizations and mass media, which may considerably complicate the activity of an individual company and make it much more costly. This situation can be considered in the light of internalization or transformation of external effect (Fig.1).

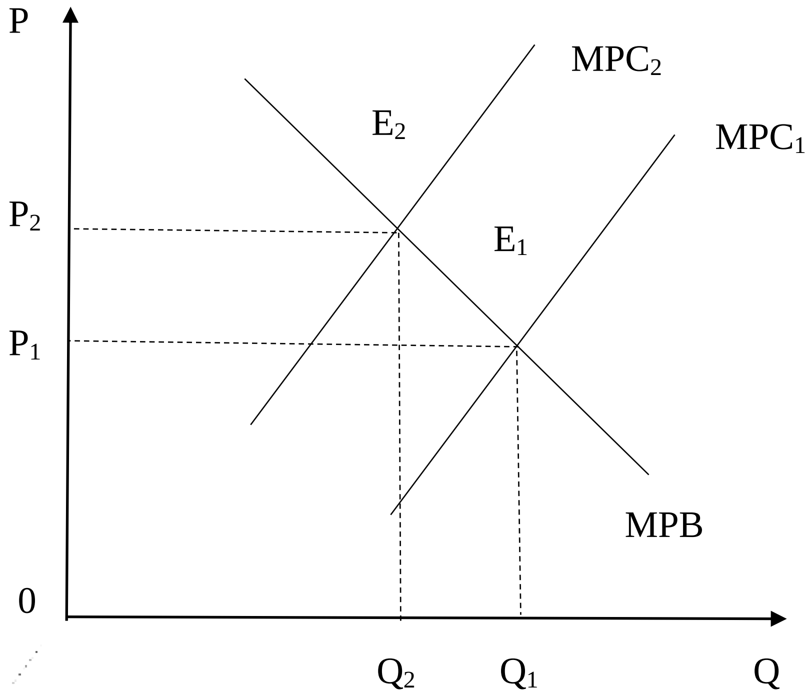


Fig.1.Company bearing additional transaction (agency) costs under the influence of stakeholders, according to the theory of associates

Fig. 1 illustrates the situation when the company feels the effect of subjects of external environment (stakeholders) leading to growth of transaction costs by$\Delta$MPC = $MPC_2 - MPC_1$. Because of growth of transaction costs of the company, its marginal private costs $MPC_1$increase to the level of $MPC_2$; as a result, equilibrium price of products grows from $P_1$to $P_2$, while the volume of product sale, on the contrary, decreases from $Q_1$to $Q_2$. MPB is the line of marginal private benefit of the company and the line of demand for its product. Consequently, increase in transaction costs causes worsening of the company performance as a whole, and therefore it is inconsistent with the interests of its shareholders and managers.

However, it is necessary to take into account that such costs for the company (shareholders and managers) are transformed into positive social and economic effect for the society; in fact, state institutions and social entities solve some of their problems at the expense of business sector. If the governmental agencies use force at the level of legislation and other regulations (standards), public and business entities exert influence within market, public, and moral-cultural mechanisms only.

This situation demonstrate show the subjects of external environment, such as governmental agencies, public organizations, suppliers, and customers can lead to increase in agency costs of the company. However, situation can be reversed when the conflicts between corporate management entities result not only in growing agency costs of the company, but transaction costs of the community as well. We mean financial fraud of the company's directors, misappropriation of funds by the company management when they are used for luxurious rooms and comfortable travels, falsification of financial statements which ultimately lead to reduction of stock prices and value of the company itself, at the best case; the worst case scenario is the company bankruptcy.

At the best, the company should carry out crisis management, which means reduction of salaries of its staff, partial dismissal of employees, raising of founders' resources, taking on new loans, additional issue of shares and bonds etc. Under these conditions, agency costs are not significant; they consist in decreasing the volumes of sale of the given company's product, lower demand for production resources, deteriorated relationship with suppliers, customers, and partners, i.e. all of the entities as above undergo some inconveniences and economic losses.

At the worst, unresolved contradictions between principals and agents are translated into bankruptcy of corporations, causing micro-waves of stagnation in the national economy. For example, it was bankruptcy of the global companies Qwest, Global Crossing, WorldCom which caused mass unemployment, disturbances in stock market, and economic decline as a whole. In this case, it is difficult to calculate agency costs and damage to the community; nevertheless, the figures will be very significant. For example, because of the series of corporate scandals during the half-year from the beginning till July 2002 the American companies lose in their value by 840 bln. US dollars. If we compare July 2002 and March 2000, taking into account dynamics of Dow Jones i NASDAQ Composite indices, investors of American companies have lost the tremendous amount of 6 tln.US dollars [5].Fig.2 shows the situation when the company, because of its agency costs, actually reduces the volumes of product offer, according to the curve S=MPC (line of marginal private costs) compared with socially desirable product offer S=MSC (line of marginal social costs). It is the result of MPC>MSC excess just by the value of marginal agency costs. In these conditions product price increases artificially, while the volume of sales falls. If the marginal private costs MPC grow over the level of the company's marginal private revenue MPR, further production is not profitable, and there are objective pre-conditions for the further bankruptcy.

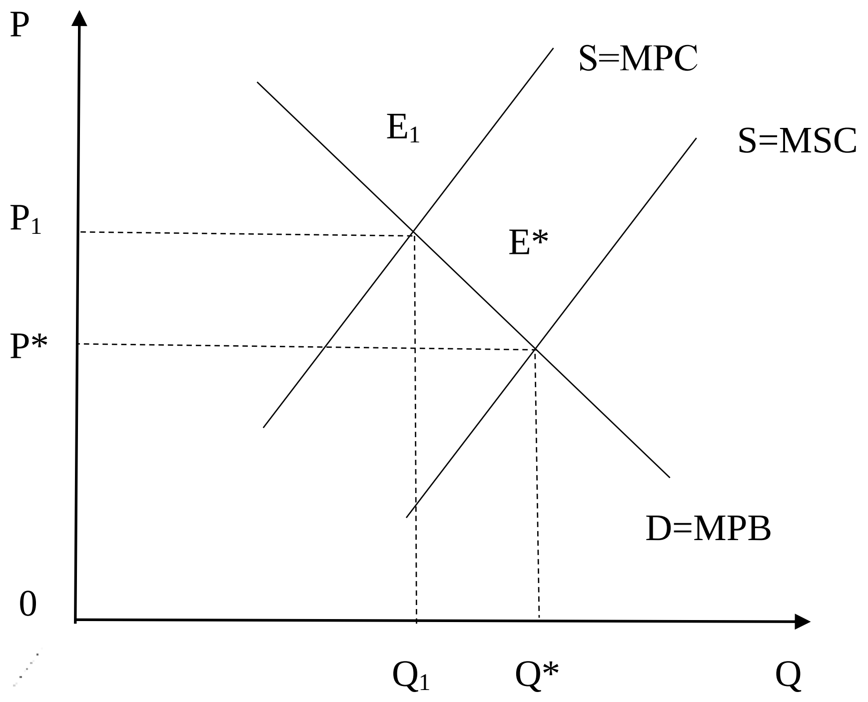


Fig. 2.Company bearing traditional transaction costs according to the agency theory

One more direction of formation of exogenous transaction costs is the interaction of company managers and shareholders with its creditors. First of all, we are talking about crediting by issue of bonds, since this form of crediting is more common today compared with conventional bank loans (it is called "securitization"). In 1985, 50% of all private investments in the developing economies fell at the international bank loans; the share of direct foreign investments was equal to 22 %, and foreign portfolio investments – 18 % only. At the beginning of the XXI century this ratio was equal to 8 %, 43 % i 48 %, accordingly [6, c. 126].

Crediting for shareholders means an additional financial leverage for obtaining profit and accumulation of shareholders' equity, which is determined as the ratio of the value of loan to the value of company's equity. It should be noted that shareholders will receive additional profit only in case if marginal return of the lending resource is higher than marginal cost for taking the loan, i.e. loan interest: MRP>MRC [7, c. 276-277].

Shareholders are interested in financing of venture projects at the expense of external crediting, because the risk of losses in this case is automatically transferred to creditors [8], if they recover their loans and interest on them only partially, or not recover at all; therefore, market value of the company's debts is reduced. Shareholders benefit from this due to increase of their capital at the expense of creditors, while benefit of creditors is in higher loan interest for venture projects [9]. Conflict of interests between shareholders and creditors consists in preferential right of creditors to receive their incomes, compared with shareholders, since redistribution of risks in favor of creditors may automatically result in redistribution of revenue also in favor of service of debts to the creditors, which is particularly important under conditions of accumulating large debts.

The important point with regard to conflicts of credit relations is their duration. On availability of better prospects of growth, the company seeks to be confined to short-term debts only, to avoid directing future incomes in favor of its creditors. In case of worse prospects, or no prospects of growth, the company is interested in long-term loans, because of no threat of loss of future incomes [10]. In any case, creditor sentering into lending relations with the corporate management entities, bear transaction costs of opportunistic nature, since they assume the economic risks of the company. When the shareholders make decisions in favor of creditors, they independently bear so called transaction costs of self-restriction.

Value of transaction costs may vary, because of additional issues of shares or bonds [11]. Issue of shares will lead to reduction of financial leverage, i.e. decrease in risks of creditors, but no revision of interest rates can be performed. Therefore, under conditions of additional issue of shares the benefits are automatically redistributed in favor of creditors, and accordingly opportunistic transaction costs of shareholders will grow [12]. On the other hand, issue of bonds will cause the increase in financial leverage, growing risks of creditors and redistribution of benefits in favor of shareholders; therefore, in this case transaction costs of creditors will accumulate. It follows that each participant of lending relations has its own interest in stability of the situation.

**Conclusions.** Transaction costs sourced from the corporate relations are formed not only within the company directly between the corporate management entities, but in the course of interaction with the other economic agents as well. First of all, the companies have to incur additional transaction costs under the influence of so called stakeholders (governmental agencies and public organizations), imposing their own requirements on the company's operations. Even if these requirements go beyond the limits of the legislative and regulatory acts, no company may ignore them. Secondly, the problems of corporate nature necessarily reflect on the growth of internal transaction costs of the company; however, any decrease in social and economic condition of individual companies means worsening of welfare of the country, and bankruptcy of companies may even have destructive consequence for the economy, therefore, corporate conflicts result in increase of transaction costs in the society as a whole. Thirdly, company's interaction with its creditors may result in accumulation of transaction costs on the part of shareholders and creditors as well. The mechanism of redistribution of benefits and transaction costs between them depends on increase of decrease in financial leverage of the company's borrowed funds.

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