Intermediaries: The Hero We Need?

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Intermediaries may not be the consumer welfare hero we want, but more often than not, they are one that we need.

In policy discussions about the digital economy, a background assumption that frequently underlies the discourse is that intermediaries and centralization always and only serve as a cost to consumers, and to society more generally. Thus, one commonly sees arguments that consumers would be better off if they could freely combine products from different trading partners. According to this logic, bundled goods, walled gardens, and other intermediaries are always to be regarded with suspicion, while interoperability, open source, and decentralization are laudable features of any market.

However, as with all economic goods, intermediation offers both costs and benefits. The challenge for market players is to assess these tradeoffs and, ultimately, to produce the optimal level of intermediation.

As one example, some observers assume that purchasing food directly from a producer benefits consumers because intermediaries no longer take a cut of the final purchase price. But this overlooks the tremendous efficiencies supermarkets can achieve in terms of cost savings, reduced carbon emissions (because consumers make fewer store trips), and other benefits that often outweigh the costs of intermediation.

The same anti-intermediary fallacy is plain to see in countless other markets. For instance, critics readily assume that insurance, mortgage, and travel brokers are just costly middlemen.

This unduly negative perception is perhaps even more salient in the digital world. Policymakers are quick to conclude that consumers are always better off when provided with "more choice." Draft regulations of digital platforms have been introduced on both sides of the Atlantic that repeat this faulty argument *ad nauseam*, as do some antitrust decisions.

Even the venerable Tyler Cowen recently appeared to sing the praises of decentralization, when discussing the future of Web 3.0:

> One person may think "I like the DeFi options at Uniswap," while another may say, "I am going to use the prediction markets over at Hedgehog." In this scenario there is relatively little intermediation and heavy competition for

> consumer attention. Thus most of the gains from competition accrue to the users.
> …
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> … I don't know if people are up to all this work (or is it fun?). But in my view this is the best-case scenario — and the most technologically ambitious. Interestingly, crypto's radical ability to disintermediate, if extended to its logical conclusion, could bring about a radical equalization of power that would lower the prices and values of the currently well-established crypto assets, companies and platforms.

While disintermediation certainly has its benefits, critics often gloss over its costs. For example, scams are practically nonexistent on Apple's "centralized" App Store but are far more prevalent with Web3 services. Apple's "power" to weed out nefarious actors certainly contributes to this difference. Similarly, there is a reason that "middlemen" like supermarkets and travel agents exist in the first place. They notably perform several complex tasks (e.g., searching for products, negotiating prices, and controlling quality) that leave consumers with a manageable selection of goods.

Returning to the crypto example, besides being a renowned scholar, Tyler Cowen is also an extremely savvy investor. What he sees as fun investment choices may be nightmarish (and potentially dangerous) decisions for less sophisticated consumers. The upshot is that intermediaries are far more valuable than they are usually given credit for.

Bringing People Together

The reason intermediaries (including online platforms) exist is to reduce transaction costs that suppliers and customers would face if they tried to do business directly. As Daniel F. Spulber argues convincingly:

> Markets have two main modes of organization: decentralized and centralized. In a decentralized market, buyers and sellers match with each other and determine transaction prices. In a centralized market, firms act as intermediaries between buyers and sellers.
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> [W]hen there are many buyers and sellers, there can be substantial transaction costs associated with communication, search, bargaining, and contracting. Such transaction costs can make it more difficult to achieve cross-market coordination through direct communication. Intermediary firms have various means of reducing transaction costs of decentralized coordination when there are many buyers and sellers.

This echoes the findings of Nobel laureate Ronald Coase, who observed that firms emerge when they offer a cheaper alternative to multiple bilateral transactions:

> The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism. The most obvious cost of "organising " production through the price mechanism is that of discovering what the relevant prices are. […] The costs of negotiating and concluding a separate contract for each exchange transaction which takes place on a market must also be taken into account.

Economists generally agree that online platforms also serve this cost-reduction function. For instance, David Evans and Richard Schmalensee observe that:

> Multi-sided platforms create value by bringing two or more different types of economic agents together and facilitating interactions between them that make all agents better off.

It's easy to see the implications for today's competition-policy debates, and for the online intermediaries that many critics would like to see decentralized. Particularly salient examples include app store platforms (such as the Apple App Store and the Google Play Store); online retail platforms (such as Amazon Marketplace); and online travel agents (like Booking.com and Expedia). Competition policymakers have embarked on countless ventures to "open up" these platforms to competition, essentially moving them further toward disintermediation. In most of these cases, however, policymakers appear to be fighting these businesses' very *raison d'être*.

For example, the purpose of an app store is to curate the software that users can install and to offer payment solutions; in exchange, the store receives a cut of the proceeds. If performing these tasks created no value, then to a first approximation, these services would not exist. Users would simply download apps via their web browsers, and the most successful smartphones would be those that allowed users to directly install apps ("sideloading," to use the more technical terms). Forcing these platforms to "open up" and become neutral is antithetical to the value proposition they offer.

Calls for retail and travel platforms to stop offering house brands or displaying certain products more favorably are equally paradoxical. Consumers turn to these platforms because they want a *selection* of goods. If that was not the case, users could simply bypass the platforms and purchase directly from independent retailers or hotels.Critics sometimes retort that some commercial arrangements, such as "most favored nation" clauses, discourage consumers from doing exactly this. But that claim only reinforces the point that online platforms must create significant value, or they would not be able to obtain such arrangements in the first place.

All of this explains why characterizing these firms as imposing a "tax" on their respective ecosystems is so deeply misleading. The implication is that platforms are merely passive rent extractors that create no value. Yet, barring the existence of market failures, both their existence and success is proof to the contrary. To argue otherwise places no faith in the ability of firms and consumers to act in their own self-interest.

A Little Evolution

This last point is even more salient when seen from an evolutionary standpoint. Today's most successful intermediaries—be they online platforms or more traditional brick-and-mortar firms like supermarkets—mostly had to outcompete the alternative represented by disintermediated bilateral contracts.

Critics of intermediaries rarely contemplate why the app-store model outpaced the more heavily disintermediated software distribution of the desktop era. Or why hotel-booking sites exist, despite consumers' ability to use search engines, hotel websites, and other product-search methods that offer unadulterated product selections. Or why mortgage brokers are so common when borrowers can call local banks directly. The list is endless.

Indeed, as I have argued previously:

> Digital markets could have taken a vast number of shapes, so why have they systematically gravitated towards those very characteristics that authorities condemn? For instance, if market tipping and consumer lock-in are so problematic, why is it that new corners of the digital economy continue to emerge via closed platforms, as opposed to collaborative ones? Indeed, if recent commentary is to be believed, it is the latter that should succeed because they purportedly produce greater gains from trade. And if consumers and platforms cannot realize these gains by themselves, then we should see [other] intermediaries step into the breach – i.e. arbitrage. This does not seem to be happening in the digital economy. The naïve answer is to say that this is precisely the problem, the harder one is to actually understand *why.*

Fiat Versus Emergent Disintermediation

All of this is not to say that intermediaries are perfect, or that centralization always beats decentralization. Instead, the critical point is about the competitive process. There are vast differences between centralization that stems from government *fiat* and that which emerges organically.

(Dis)intermediation is an economic good. Markets thus play a critical role in deciding how much or little of it is provided. Intermediaries must charge fees that cover their costs, while bilateral contracts entail transaction costs. In typically Hayekian fashion, suppliers and buyers will weigh the costs and benefits of these options.

Intermediaries are most likely to emerge in markets prone to excessive transaction costs and competitive processes ensure that only valuable intermediaries survive. Accordingly, there is no guarantee that government-mandated disintermediation would generate net benefits in any given case.

Of course, the market does not always work perfectly. Sometimes, market failures give rise to excessive (or insufficient) centralization. And policymakers should certainly be attentive to these potential problems and address them on a case-by-case basis. But there is little reason to believe that today's most successful intermediaries are the result of market failures, and it is thus critical that policymakers do not undermine the valuable role they perform.

For example, few believe that supermarkets exist merely because government failures (such as excessive regulation) or market failures (such as monopolization) prevent the emergence of smaller rivals. Likewise, the app-store model is widely perceived as an improvement over previous software platforms; few consumers appear favorably disposed toward its replacement with sideloading of apps (for example, few Android users choose to sideload apps rather than purchase them via the Google Play Store). In fact, markets appear to be moving in the opposite direction: even traditional software platforms such as Windows OS increasingly rely on closed stores to distribute software on their platforms.

More broadly, this same reasoning can (and has) been applied to other social institutions, such as the modern family. For example, the late Steven Horwitz observed that family structures have evolved in order to adapt to changing economic circumstances. Crucially, this process is driven by the same cost-benefit tradeoff that we see in markets. In both cases, agents effectively decide which functions are better performed within a given social structure, and which ones are more efficiently completed outside of it.

Returning to Tyler Cowen's point about the future of Web3, the case can be made that whatever level of centralization ultimately emerges is *most likely* the best case scenario. Sure, there may be some market failures and suboptimal outcomes along the way, but they ultimately pale in comparison to the most pervasive force: namely, economic agents' ability to act in what they perceive to be their best interest. To put it differently, if Web3 spontaneously becomes as centralized as Web 2.0 has been, that would be testament to the tremendous role that intermediaries play throughout the economy.

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