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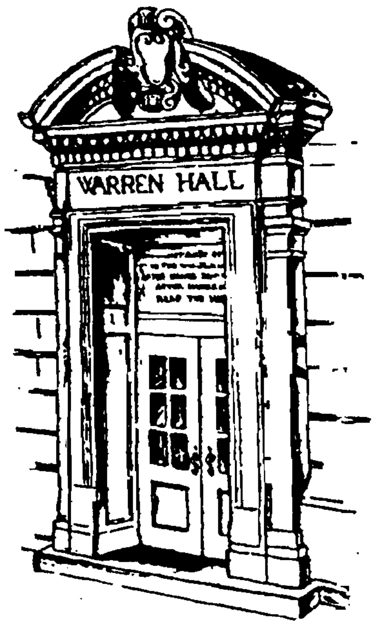

Staff Paper

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PUBLIC INVOLVEMENT IS ABSOLUTELY NECESSARY FOR MARKETS TO BE EFFICIENT: AN OVERVIEW

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Public Involvement is Absolutely Necessary for Markets to be Efficient: An Overview

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Public involvement in setting rules and establishing regulations on transaction processes in market economies is absolutely **necessary** for markets to be efficient. **But rules by themselves are not sufficient. To be sufficient the rules and regulations must be enforceable and enforced.**

The difference between a market economy and a centrally planned and controlled economy is not that one has rules and the other not. The rules are just different. In both economies there must be exchange mechanisms, marketing institutions and rules about how they operate. In many instances the objectives of both type economies are similar - economic growth, full employment, and a reasonable living standard for all. In a planned economy the rules relate to actual production goals and quotas and the specific decisions about the establishment of transfer prices. In a market economy the rules relate to the **process** by which prices are discovered. Prices are discovered in the market place, not made. Prices become a signaling device.

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In a market economy the government establishes rules about the marketing and price discovery process. In both the planned economy and the market economy, the government interferes in the price discovery process at the risk of an incorrect allocation of resources. But in a market economy, changes in market conditions are permitted to show up in price changes. The difference is not in what government hopes to achieve but in the manner that it goes about doing it.

In the early transition period from a centrally planned economy, there appeared to be a strong belief that moving to a market economy meant eliminating all of the rules that regulate the way an economy works; that markets would automatically evolve. However, without preexisting institutional arrangements that facilitate transactions, (that is, rules and regulations of the transaction processes between buyer and seller), chaos will certainly prevail. And chaos did prevail and still does in many places in the world.

A colleague has written, "Markets are signaling mechanisms, but markets cannot function in a world without structures of one form or another. Markets, if they are to represent legitimate signalling, must function so as to hold down: (1) the costs of obtaining information about possible market opportunities, (2) the costs of negotiating contracts or bargains among market participants; and (3) the costs of enforcing bargains or contracts that have been struck. We call these costs transaction costs." (Bromley)

A useful criterion for deciding the degree of government involvement should be - will it hold down or reduce transaction costs. While transaction costs are being held down, prices must be allowed to move so as to bring forth, in the short run, the matching of market supplies with market demand and in the long run, an efficient allocation of resources. And this can be done only if transaction costs, including risk, are minimized.

Economies in transition have a tremendous challenge in evolving the proper set of institutional marketing arrangements and the rules that govern their operation. Marketing institutions in the western world have evolved over a long period of time into an incredibly complex system of markets that operate under a very complex set of private and public rules. For the food industries of transition economies to operate in competition with the food industries of the western world, they must establish in a relatively short time, marketing institutions and rules that have transaction costs comparable to those in the western world. High transaction costs are as much of a barrier to being competitive in those markets as are the existing trade barriers.

The Government's Role

Areas in which the government has a legitimate role in a market economy are: the establishment of contract and bankruptcy law, regulating the price discovery process, ensuring some degree of competition, and assisting producers in the orderly marketing of their output. I will discuss each briefly.

Contract Law, Grievance Procedures and Bankruptcy Law

Each transaction in a market economy involves some agreement or contract between buyers and sellers, i.e., the owners of goods or services that have something to sell and the potential owners who want to buy. Institutional arrangements whereby each participant can expect the other to fulfill their part of the contract must exist. In the case of failure to pay or to deliver there must be a procedure to redress or recover the lost opportunity. These laws or rules must be viewed as being just and timely. The laws or rules must be simple enough and the level of intervention minimal enough so as to hold down transaction costs. Others are more expert than I on contract law, therefore I will only emphasize that rules about contracts must exist and there must be a way to settle disputes.

Price Discovery Processes

In a market economy, governments should be primarily concerned about the price discovery process, not the level of prices. The price discovery processes, no matter the institutional arrangement, need to be efficient in determining the appropriate value of the commodity. It is important that one side of the transaction not have too much power over the other through controls over supplies or markets, nor access to more information than the other so as to unduly influence the outcome.

There needs to be rules to regulate the way buyers and sellers relate to each other. **The rules need to be rigid yet flexible. Rigid**, so that market participants, both parties (buyers and sellers have some confidence that transactions will be completed with minimum risk and at minimum cost). **Flexible**, in that participants have choices among alternative price discovery mechanisms. **Flexible**, so that rules can be adjusted to account for changes in communication technology and changes in the structure of institutions involved in producing and distributing goods and services.

Rules do make a difference, but the kinds of rules that are appropriate depend on the type of price discovery process. I will discuss three types of exchange mechanisms or price discovery processes.[1] They are 1) private (informal or formal) negotiations, 2) auctions or organized markets and 3) private or public administered prices. I caution that the appropriate set of institutional arrangements, the rules and enforcement procedures that are appropriate, are likely to be somewhat different for each country, depending on that society's culture and traditions. No fixed prescription for any one country exists. Furthermore, the institutions and rules need to change over time to fit changes in marketing conditions and marketing technology.

In what follows, I will describe the three types of exchange mechanisms and an appropriate government role for each.

I thank William Tomek for suggesting this classification.

Private (Informal or Formal) Negotiations

In market economies, most actual transactions are by individual negotiation. Buyers and sellers meet in person or by phone and agree to trade at a price. The terms of the transaction, including the price, might be informally agreed upon or might be in the form of a formal written contract. The price might be negotiated on each transaction or a **formula** for determining price might be agreed upon. For the transaction to be satisfactory, both parties must perceive the risk of completing the transaction to be minimal, and in terms of alternatives, profitable. This does not mean that both sides will be happy with the absolute level of price. If the market is working efficiently the absolute price level will be determined, in large part, by forces external to the transaction.

In the US, the majority of transactions in the agri-food industry are by private negotiation. Sometimes the negotiation about price occurs on each transaction, however in many arrangements the transaction price is determined by formula. The basis element of the formula might be a price for the same or closely related commodity, that has been discovered through some other institutional arrangement. For this individual transaction to be efficient, the open market price must be efficiently discovered and represent all of the supply and demand forces at work in the economy. The open market price can be from an organized cash market (auction or central exchange) or a futures market.

A **proper role of government** for this type of exchange process is minimal. Contract law must be enforced. An information system must be established to provide each side of the negotiation valid and sound information about market conditions and prices. Direct intervention should be minimal or not existent. The information could be provided by government agencies, or the government could make sure that the private sector provides reliable information about the current supply and demand conditions and market (actual transaction) prices. These must be provided on a current basis, be relatively accurate and disseminated widely, especially to interested parties. In some instances, a private news service can be more effective than government. There is nothing certain about the government being more effective than the private sector in providing accurate and timely information. The decision over government versus private sector involvement should be made on the basis of minimizing transaction costs.

Auctions and Organized Markets

For most of the major agricultural commodities, organized markets are used to determine value or price. And in organized markets, the rules really do make a difference. Organized markets can come in many forms, from local auctions to large central exchanges. They can be face to face with the product physically present or they can be by contract with a remote electronic transaction system. To be efficient, the rules about ownership and operation of the exchanges must be specific, well known and enforced.

The rules can be from government or established by the private operators of the organized markets. Terms of trade must be specified. Charges must be minimal. Transaction prices must be public and widely delivered. There must be penalties for non-delivery of the commodity or items according to the terms of trade agreed upon. And the organized market must be large enough to achieve adequate economies to scale to reach that goal of minimizing transaction costs. As a minimum, it is probably necessary for the government to establish an oversight agency to make sure that the rules and the way the organized markets operate are in the public interest rather than in the interest of one side of the transaction.

Organized exchanges in the US are almost all privately owned and operated and they establish their own operating rules. They are self supporting with operating revenue coming from user fees. The governments role is to make sure that they do operate according to their own rules (contract law) and that they operate according to the rules set down in their charter. Specific rules concern quality, grades and standards, and honesty in providing information. In most cases, a third party system is used to guarantee quality and to settle disputes. In this arrangement, the exchange will continue to be in business only as long as transaction costs for the commodity group are lower using this system than from using another system.

Administered Pricing Mechanisms

Where privately administered pricing arrangements exist, the government's role is minimal but important. To make sure that the firm or firms that have the power to post prices do not also have the power to develop or maintain a monopoly position in the market, the government needs to make sure that the buyers have options and that the trading field is balanced (i.e., no side of the buying or selling group has undue power over the other in the negotiations over price, etc).

This can be accomplished in some cases through some form of anti-trust law. Administered pricing in most developed countries is common on the farm input or buying side of agriculture. There are usually a few firms supplying the agricultural sector and these firms have some form of monopoly power. In some of the countries in transition, this firm is the government. In this situation, the government's role is probably best served by making sure that a private sector exists along-side the government side. This will provide competition and ensure that the government is operating efficiently.

Administered pricing can involve price posting by an exchange or a private firm that collects market information. This means that enough information is known about the market that a close approximation can be made of the market clearing price. Some private market news services publish price quotations that are used as a basis (formula) for pricing individual private transactions. Here the government's role should be minimal.

The quotation will only be used by buyers and sellers if they feel that the quotation properly represents market conditions at the time. Again the focus of government should be on making sure that buyers and sellers have options and that information is published and available about market conditions and actual transaction prices.

Regulating the Degree of Competition

The extent to which firms are competitive in a market economy, determines in large part, the economic efficiency of that economy. Several agri-food firms need to be in competition with each other in order to ensure that the prices are efficient and that transaction costs are kept low. To accomplish this, government needs to have some form of anti-trust law and/or some form of unfair trade practice law. In addition, it might be necessary to provide some segments of the agri-food sector an exemption, if that sector, even with reasonably enforced anti-trust laws, is at a competitive disadvantage. In the US, this type of exemption is applied to farmer owned cooperatives so that farmers can compete against a highly concentrated supply and marketing sector.

Orderly Marketing

In an open market environment, the prices of agricultural commodities are usually quite volatile because of the many factors, especially weather and disease factors, that cause production to vary substantially from year to year. When this is the case there is a tendency for government to want to control prices. This tendency must be resisted. If the government or the farmers want to influence the price of their commodity, there are other options. One is to influence the market supply by a storage policy, a flow to market regulation, or a demand expansion program. The government can establish enabling legislation for self help programs such as marketing orders that regulate quality, grades and standards, storage policy, research and promotion. If the industry pays for and manages their own programs with the enforcement power of the government, the programs will be self policing. Whatever efforts are exercised on behalf of the producers will have to generate enough revenue from the market over the long run in order for the effort to survive.

Closing Comments

The criterion that would seem most useful in determining the extent of government involvement is as follows: Are the rules and regulations of government and private exchange organizations consistent with minimizing transaction costs? Are they rigid enough to ensure confidence and a perception of minimum risks? Are they flexible enough to ensure creativity in generating new exchange mechanisms and in permitting innovation in economic activity?

The western world has a myriad of rules and regulations on the enforcement of contracts, protection of property rights, antitrust laws, restrictions on insider trading, restrictions on cornering the market, collection and publishing of price and other market information, public reporting of financial data of privately owned firms, etc. to keep markets working efficiently. In most countries, the current rules started to evolve over 60 years ago. And they are still evolving.

Making agri-markets efficient involves getting the rules "right", it does not involve getting prices right; the market process determines the "right" price.

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