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Discussion Paper 195

Market Institutions: Enhancing the Value of Rural-Urban Links

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Emerging local and global patterns, including urbanization, agro-industrialization and the rise of supermarkets, and trade liberalization, require synergies rather than divisions between rural and urban areas if farmers in poor countries are to benefit. For instance, better rural-urban linkages can ensure an adequate food supply for the city at affordable prices, and rural areas can serve as outlets for goods produced in urban areas. In the absence of strong rural-urban linkages, urban areas might face food shortages and rural areas might be left out of globalization, both as consumers and producers.

To generate benefits, policymakers must strengthen the links between rural and urban markets. But market reforms such as trade liberalization and decentralization may not by themselves be sufficient to reduce the costs of exchange and induce rural-urban interactions. In many countries, poor infrastructure and institutional barriers also increase costs, stifling market exchange between rural and urban producers and sellers.

Purpose of this Paper

This paper examines the role of market institutions[1] in reducing barriers and costs to exchange. Reducing costs will encourage greater market integration and ultimately bolster growth and reduce poverty in both urban and rural areas.

Obstacles to Rural-Urban Exchange

Several interrelated factors affect transfer costs and consequently the degree of rural-urban linkages in goods markets. (Transfer costs include costs of transportation and information, taxes, social barriers to market participation, and costs of undertaking the transaction, such as finding partners, reaching and enforcing contracts, and monitoring information.)

Five major types of transfer costs impede market exchange:

1. Information asymmetry: one participant in the transaction has more market information, especially on prices, than the other, and uses it to his or her advantage;
2. Transaction costs: taxes, fees, bribes, and time spent to accomplish transactions;
3. Costs of transport and communications;
4. Policy-induced barriers: suboptimal institutional arrangements, including governance issues; and
5. Noneconomic barriers: lack of education, or social customs and laws that exclude certain groups, such as ethnic groups or women, or give other groups special advantages.

Market institutions can play a catalytic role in reducing barriers and costs to exchange. Reducing these costs will encourage greater market integration between rural and urban areas and ultimately bolster growth and reduce poverty.

Reducing Transfer Costs

Using examples from five countries, the study describes some ways to positively address the five major types of transfer costs, with a special focus on reducing costs through improved institutional arrangements.

(1) **Information asymmetry: Modernizing the food-value chain**. In a modernized food-value chain, supermarkets and agribusinesses deal with producers and consumers directly. With fewer intermediaries, traders have fewer opportunities to exploit or garble information, and farmers can spend less time searching for and verifying information. With closer connections to consumers, businesses are better able to provide guidance, telling Indonesian producers, for example, what kind of green pepper a consumer in Jakarta wants. Of course, policies must ensure that supermarkets, agribusinesses, or large farmers do not monopolize information, markets, or technologies. Farmers still must be able to choose which products they grow, verify information independently, and seek the best deal from a variety of clients.

(2) **Transaction costs: Producer cooperatives**. Small farmers may need to band together to pool risks and create economies of scale that allow them to compete with larger producers or bargain with vendors who prefer to deal with only one large producer. Though some cooperatives become managerially top-heavy and welfarist, many provide significant benefits to their members. Dairy cooperatives in Ethiopia and Kenya have aggregated producers' production to supply the large quantities demanded by urban markets. They have also invested in

[1] Here the term "institutions" refers broadly to the set of formal and informal arrangements and rules of conduct that shape human interaction. This study focuses on institutions that affect interactions in the goods market.

marketing and processing services that did not make economic sense for individual farmers operating alone.

(3) **Transport and information costs: Better telecommunications**. Reliable, affordable, and convenient telecommunications encourage market exchange. Producers can access the market information they need. Urban businesses can reduce search costs among rural suppliers. In a study of village telephone use in Bangladesh, almost all calls went to urban areas. One-third of calls were for business purposes (getting market information, making deals), 27 percent were to family and friends (sometimes also business-related), and 10 percent were to look for a job. A study in Peru found similar results.

(4) **Policy barriers: Governance**. Even well-intended policies can create barriers to rural-urban integration. In Ethiopia, for example, localities received some taxing authority intended to improve the effectiveness of decentralization. Several local and regional authorities, however, set up checkpoints at their administrative borders, charging fees that substantially increased the time and cost it took to transport grain from producer to market, even within the country, fragmenting the goods market further.

(5) **Noneconomic barriers: Antidiscrimination policies**. Social barriers, such as ethnicity, race, culture, and language, can also add to transfer costs. Social exclusion can impede the access some individuals have to certain markets or specific jobs, or their ability to acquire certain assets. Social customs may prohibit women from traveling, working, or owning land, for instance. Local authorities may exclude indigenous or low-caste communities from decisionmaking forums, or restrict certain jobs to specific ethnic groups. Beyond social harm, in economic terms, exclusion restricts markets participation, size, and competition, preventing individuals from migrating to obtain new jobs with higher wages or from getting access to lower-priced goods and services.

Policy and Program Challenges

Institutional innovations—supermarkets, dairy cooperatives, and rural telephony, for example—can play a catalytic role in reducing transfer costs and enhancing rural-urban linkages. Policy reforms to reduce transfer costs must not only liberalize prices or invest in infrastructure but establish sound institutional arrangements to help agricultural producers and other businesspeople overcome barriers to the flow of goods, services, and resources between rural and urban regions.

In sum, to encourage resources to flow where they will have the greatest economic and social benefit, policies must:

- Complement the removal of market price distortions with the reduction of institutional barriers to rural-urban trade, including investment in physical and social infrastructure;
- Provide potential market participants, especially marginalized and vulnerable groups, with the mechanisms, knowledge, and right to participate in markets; and
- Pay special attention to areas where markets are missing or not competitive and may need regulation or assistance to overcome institutional barriers.

Keywords: market, institution, value, rural-urban, Bangladesh, Ethiopia, Indonesia, Kenya, Peru

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