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The Economics of Mandatory Regulation

In the aftermath of the spinach/E. coli 0157:H7 disaster, the Western Growers Association quickly came to the conclusion that mandatory regulation was required and proposed a mandatory marketing order mechanism to make it happen. More recently, the United Fresh Produce Association issued a statement calling for mandatory regulation on the federal level.

The explanation given by each association was that only mandatory regulation can rebuild regulatory and consumer confidence. They see it as a practical response to practical realities. The affirmation of mandatory regulation by industry groups that had previously resisted anything mandatory is entirely predictable based on the interests of the vast majority of the members of these associations.

The issue is how society creates an incentive structure that will result in safe food, including safe fresh produce. There is an entire field known as "Information Economics" that provides a foundation for understanding the problem. The root of the issue is that safety in fresh produce is what economists call a "credence attribute" — meaning people have to take it on faith, give it "credence," because there is no way for a consumer to tell how safe the produce is before purchase or even before use. The comeuppance of this is that anything that would reduce "credence" — such as an outbreak — tends to affect the entire product category.

Some markets are characterized by "asymmetric information" — that is, buyers or sellers have more information than the opposite party. So in reference to ready-to-eat produce, the seller knows whether these products have been grown and packed under a world-class food safety system, but the buyer does not.

In a market such as this, there is a powerful incentive for sellers to pass off a lower quality good, or, in this case, a product raised in a sub-standard food safety system as being world-class.

The buyer, however, quickly catches on to the seller's incentives and refuses to give "credence" to above-average status for any product. This refusal to pay value for above-average product makes it difficult to justify the investment in producing above-average product and, as a result, the above-average product gets driven from the market.

A famous example is India in the 1970s, where it was difficult to find good quality fresh milk. Why? Many merchants watered down their milk to maximize profits. Since consumers had no way to judge the quality of the milk, they began assuming it was watered down and would only pay low prices for it.

This made it impossible for legitimate producers to make a living and thus virtually all milk was poor quality. The bad drove out the good. The Indian government eventually moved in, distributed machines to test butterfat content, created brands to build buyers' trust and, eventually, milk quality got better.

Mandatory regulation will result in lower food safety standards.

The use of brands is telling. A study by the USDA's Economic Research Service on food safety innovation in the meat industry found that "Branding helps firms appropriate benefits from food safety innovation" and that "First movers appropriate the benefits of innovation."

Put another way, in an economic sense, if we want food safety we need to create incentives for it. The normal incentive is that when a company has an outbreak, it should lead buyers — especially sophisticated trade buyers such as those leading retail, foodservice and wholesale companies that have signed on to the Buyer-led Food Safety Initiative — to switch their purchases to early adopters of stringent food safety standards.

In other words, those companies that spent money on food safety will get rewarded through more business; those who skimped will go out of business. This incentive structure will encourage companies to invest in food safety because they can expect to be rewarded when their competitors have problems.

At this point, a call for mandatory regulation is a classic competitive maneuver. Impose an industry-wide standard, give that standard a Seal-of-Approval and thus prevent the early adopters of stringent food safety standards from seizing the advantage that should be theirs.

Inevitably the standards adopted improve industry performance on food safety, but not to the level of the top performers. And, in fact, the current draft Good Agricultural Practices document calls for safety standards much lower than those used today by the companies with the best food safety programs.

A mandatory program may be a good public relations move for the industry because most politicians and most consumers think passing a law will solve the problem. The truth, however, is that mandatory regulation will result in lower food safety standards than there would have been if the early adopters of stringent standards were allowed to take their "market rent" and drive the underperformers out of business. After all, those buyers that demand the associations create new standards could just decide to pay the price and buy from the companies with sterling food safety programs right now.

In the long term, mandatory regulation will reduce the incentives for companies to invest in new food safety procedures because it will be difficult to get a return on that investment. It is wonderful that Fresh Express has donated $2 million for research on E. coli 0157:H7 and that PMA has set aside $2.75 million for a food safety program — but in a market-based economy, a vital element of the system of production, such as safety, should not, and does not, depend on the kindness of strangers. It depends on companies seeing the possibility of a return on investment.

Mandatory regulation reduces that possibility. **pb**