

4-1-1985

## Barter Clubs and Exchanges: A New Source of Inefficiency and Risk

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### Recommended Citation

Bornhofen, John O. (1984) "Barter Clubs and Exchanges: A New Source of Inefficiency and Risk," *Seidman School Management Memo*: Vol. 5: Iss. 2, Article 1.  
Available at: <http://scholarworks.gvsu.edu/ssmm/vol5/iss2/1>

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# Barter Clubs and Exchanges: A New Source of Inefficiency and Risk

By John O. Bornhofen

Over the past several years, a relatively new development has occurred on the American economic scene—the emergence of barter clubs and exchanges. In both clubs and exchanges, members swap goods and services and receive “points” (credits) in return.<sup>1</sup> (Typically, each point is supposed to be worth one dollar in value.)

The major reason for barter in modern-day industrial America appears to be avoiding taxes on income earned. Many barter participants apparently believe that since barter transactions don't involve the exchange of money for services rendered or goods sold (traded), the (real) income obtained in the transaction is not taxable. This notion is, of course, incorrect. For instance, a gas station owner who swaps gasoline or auto repairs with an electronics store owner for a new cassette recorder is receiving income, but it is real or in kind rather than in cash. The electronics store owner, likewise, is receiving income in real terms. The value of the transaction is taxable to both.

The thrust of this article is not about taxes, however. It is about barter as an economically defective way to conduct trade. Although barter clubs and exchanges reduce some of the disadvantages of straight barter, they create other problems, which I will discuss later.

## Inefficiencies of Barter

In a straight barter transaction, goods and services are traded for other goods and services. That's simple enough. But people with goods and services to trade must find other people with whom to trade. Thus, someone who wishes to swap a stereo for a pair of skis must find someone who has the right pair of skis and wishes to trade them and wants a stereo of a particular kind. Such a person could be rare and hard to find.

This need to find someone who has what we want and wants to trade for what we have is known as the “double coincidence of wants.” The wants must coincide for a trade to take place. Finding this person could be a lengthy and costly process. Phone calls, ads, and time spent in search all add up to high transaction costs.<sup>2</sup> Even in the case of barter clubs and exchanges, the inefficiency is easily seen since they typically charge their members a percentage (often 10 percent) of the value of the transaction.

Thus, barter is generally a very costly way to exchange goods and services. Using money as a medium of exchange is far more efficient. Since everyone accepts it, by definition the double coincidence of wants doesn't exist and the transaction costs are as low as possible.

## The Function of a Club

The first function of a barter organization is to act as a clearing house for information about who has what to trade and (possibly) what the trader wants in return. By going to a central place with their wants, traders reduce their search costs. The exchanges often publish catalogues listing members and the goods and services they supply. Thus, the clubs reduce the costs of making barter transactions. So far, so good, but modern barter organizations do more.

Typically, they set up a system of deferred payments whereby a person can supply some good or service to another when the other has nothing simultaneously to trade that the first person wants. For instance, through the organization, Mr. A, who has a bushel of potatoes to trade and wants a bottle of tequila, can supply the potatoes to someone who currently has no tequila to trade, or for that matter, has nothing whatsoever to trade (that interests A). Instead of getting goods and services immediately, A gets “trade units” or “points” from the barter organization for the value of the

potatoes. The units are then put into an account for A and can be used immediately to get goods and services from others, or they can be used later. This arrangement reduces the problem of the double coincidence of wants.

However, there is the problem of deferred payments—payments of goods and services in the future. With any deferred payment, there is a question of whether the payment will actually be made. Will the persons making the promises to pay actually be willing and able to carry them out when the time comes? The possibility that they will not is called “default risk.”

With regular money, default risk is minimized through the high financial soundness, integrity, and reputation of the money issuers—typically the national government, the central banks, and/or the depositing financial institutions, such as commercial banks. In the case of banks, there is the additional reduction in default risk through the use of deposit insurance. Thus, the default risk on the assets we use as money is as low as possible.

In the case of barter exchanges, the exchange typically issues the trading units or points. It owes them, and the default risk is that it will not be willing or able to honor them. If the club or exchange were to fold or the operators leave town, members could be left with worthless points and be lacking the goods and services they supplied. Indeed, there have been recent reports of people having supplied major assets such as houses or land in exchange for points and not being able to use them. In less egregious situations, people have eventually been able to sell the points back to the exchange for money, but at big discounts. In another case, a barter organization went bankrupt, and the operators reputedly started a new one allowing members in the bankrupt one to transfer units into the new one but at sizeable discounts.

In addition, the possibility exists that the operators of the barter organization can obtain goods and services for their own use and issue trading units on the group's behalf to the suppliers. The temptation must exist for operators to do this on a large scale and then abscond with the goods before the units can be used. The possibility that this can happen also means default risk to the holders of the units.

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# Distinguished Speakers at Seidman

Robert Lund, Senior Vice President of Marketing at General Motors, spoke to students, faculty, and staff Thursday, November 15. His topic was "The Leadership Role of the United States in Automotive Marketing." He also met over lunch that day with fifteen Seidman School Affiliates to discuss domestic automotive production and the Michigan economy.

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Dr. Steven Skancke, former Staff Director of the White House Conference on Productivity and Deputy Counselor to the Secretary of the Treasury, spoke to students, faculty, and staff Wednesday, December 5. His topic was "Profits and Productivity: Recipes for Success." He met with Seidman faculty at a luncheon to explore a number of productivity issues. Dr. Skancke is Vice President of G. William Miller and Company.

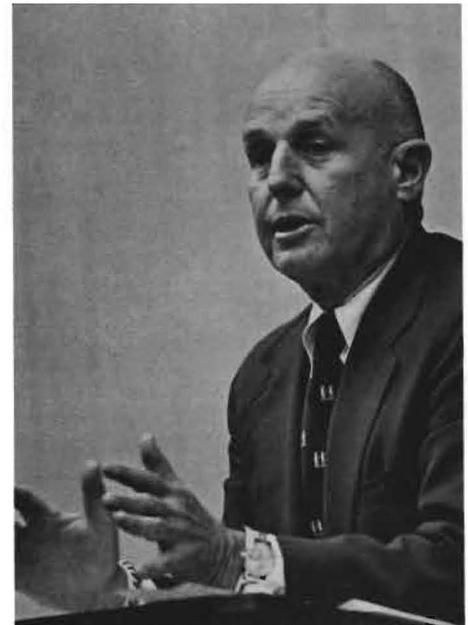
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Dr. James Buchanan, Director of the Center for the Study of Public Choice at

George Mason University, was in Grand Rapids and on campus on Thursday, April 18. He spoke to west Michigan area economists at a breakfast meeting, to the Seidman School Affiliates at lunch, and to the Grand Valley students, faculty, and staff in the afternoon. His topic at the luncheon meeting was "Federal Deficits and the Ethics of Default," and his speech on campus was entitled "Public Choice Perspectives and the Ethics of Default." Dr. Buchanan's many publications include *The Economics of Politics*, *The Calculus of Consent*, and *Fairness, Hope, and Justice*.

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L. William Seidman, Dean of the School of Business at Arizona State University, spoke to students, faculty, and staff Thursday, April 25. His topic was "Productivity and Quality in the United States." Mr. Seidman served as Economic Policy Coordinator for President Gerald R. Ford from 1973 to 1976 and as Executive Vice President for Phelps Dodge Corporation from 1976 to 1981.



L. William Seidman

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These possibilities mean that additional costs might have to be incurred to reduce default risk. Potential members may have to investigate the exchange and its operators and their track records and credit standing. Thus, as transactions costs are lowered by reducing the double coincidence of wants, other costs and risks are higher. But, whatever the mix of costs incurred and risks taken, their total is higher with barter than with the use of conventional money.

It should be noted that the units or points produced by barter groups are an attempt to create another kind of money—an inferior one at that. The use of this "money" is limited to the members of the barter group, of course. It has no acceptability outside the group.

In effect, barter organizations are an in-between case, between straight barter, on the one hand, and the use of money, on the other. They issue a form of money but a limited one.

### Inefficiency in Supply And Demand

Another source of inefficiency with bartering is that the prices at which trades take place are not necessarily equal to the "equilibrium" price. This occurs because of the limited market for bartered goods and services, whether that stems from the double coin-

cidence of wants or the limited number of trading partners in barter organizations.

At this point, you will realize that even though goods and services may be bartered, they are traded at "prices." The price of a good or service in a trade is how much of something else is given up for it. A price is an "exchange ratio." For example, if three chickens are traded for one pig, the exchange ratio (the price) of pigs in terms of chickens is three, and the price of chicken in terms of pigs is one-third.

The equilibrium price ( $P_e$ ) at any particular time is the price that balances the supply of the goods or services being traded with their demand. Consider widgets as the good being traded in a competitive market.  $P_e$  is the equilibrium price of widgets. At  $P_e$ , the number of widgets demanders want is equal to the amount of widgets offered for sale. At  $P_e$ , there are no widgets left over and there are no unsatisfied demanders who are willing to pay  $P_e$ .  $P_e$  could be thought of as the "true" price of widgets. The higher the proportion of transactions that take place at  $P_e$ , the more perfect the market. However, the more transactions that take place away from  $P_e$ , the more imperfect the market.

In barter, the source of this market imperfection and inefficiency is the fact that markets for bartered goods are much smaller than

those for the identical goods bought and sold in regular markets with money. Consider a combined market for widgets in which most are sold and a few are bartered. In a perfect market with efficient prices, the price of widgets throughout this combined market should be the same for identical widgets, regardless of whether the widgets are traded for money or for other goods and services. However, because there are fewer transactions in the submarket for bartered widgets and fewer possible trading partners, the prices of bartered widgets can be very different from those of widgets bought and sold for money. A person offering widgets in the barter submarket might get a lower exchange ratio (lower price) than would be the case in the monetary market. Similarly, someone needing widgets might pay a higher price than in the regular market. In fact, it has been reported that some business suppliers of goods and services have vastly different prices for their products, one price for the regular market and another (much higher) for the barter market.

There is no guarantee that the goods and services that people want will be supplied through the barter organization. Tremendous imbalances can occur between supply and demand within the barter submarket, and they can allow transaction prices there to be considerably different from the true prices.

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The difference between transaction prices and the true, or equilibrium, prices could also distort resource allocation by giving off false signals about the values of goods and services traded. When scarce resources are misallocated, and some other goods and services are forgone, there is waste. This waste is known as "allocational inefficiency."

## Avoiding Taxes

One reason buyers might submit to these inferior prices is tax evasion. They might be willing to pay the higher prices if the percentage price differential is smaller than the tax rate and if the trades can be concealed from the tax man. Thus, people might be willing to pay up to 50 percent more for goods or services if their marginal tax rate is 50 percent.

Barter organizations do reduce the original problems of double coincidence of wants and high transactions costs but substitute in their place default risk, an inferior type of money. But the basic inefficiency associated with barter still exists and causes a suboptimal allocation of scarce resources in the overall economy.

Why then do we waste resources this way? To answer that, we must go back to tax evasion. People are attempting to escape high marginal tax rates on income through the concealment of barter transactions. Presumably, the reduced tax load to an individual barterer offsets the additional transactions costs, inferior prices, and/or default risk incurred. Even though this makes sense on the micro-economic level, there is waste and inefficiency on the macro, or social, level. Costs are higher to conduct a given amount of production and trade through barter or barter organizations than with money. Resources used to carry out

barter and cope with increased default risk are resources that don't produce other goods and services. Thus, the economic well-being of people is reduced.

## Can Barter Be Eliminated?

What can be done to rectify this misallocation of scarce resources? There are several possible approaches. First, marginal tax rates could be reduced to make barter less appealing. However, it is unlikely that rates can or will be reduced enough to discourage this practice. Second, enhanced knowledge of the costs and risks of barter and barter clubs on the part of potential barterers would reduce some of the practice. If people have a general idea of the search costs involved in overcoming the double coincidence of wants, the possibility of inferior prices, and the risk of default by other traders or barter clubs, the incidence of barter should be reduced. Barter will not be eliminated, however, as long as high marginal income tax rates exist.

Third, having the authorities make sure they tax barter transactions that produce income for the barterers would also reduce the incidence of barter and its attendant waste. In this regard, the IRS has recently required that each barter exchange report the gross transactions for each member on Form 1099's.

If barter clubs were required to record the name of each person who makes a trade, the type and amount of goods and services traded, and the amount of credits awarded in return, the value of the income-producing transactions could be determined.<sup>3</sup> This disclosure would be expected to raise the cost of operating the clubs and to reduce their attractiveness as tax-evasion devices.

In conclusion, resort to barter and barter organizations amounts to high transactions costs, inefficiency in the use of our scarce resources and increased risk, throughout the economic system. While barter organizations convey benefits, they also involve costs and risks that, at the macro level, outweigh the benefits.

The root cause of all this appears to be high marginal tax rates on income. But even if trading through barter organizations is recorded, taxed, and reduced, individuals can still revert to straight barter, which is even more inefficient.

<sup>1</sup> The difference between barter clubs and exchanges appears to be that the former are made up of individuals whereas business firms comprise the latter. Barter exchanges are sometimes called trade exchanges.

<sup>2</sup> All costs represent what is given up to pursue one alternative rather than others. Costs are usually measured in money terms, but an out-of-pocket payment in money is not necessary for a cost to occur.

<sup>3</sup> Not all barter transactions are taxable income-producing transactions. Many are non-taxable because they involve personal (as opposed to capital) assets or personal expenditures.

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# Economic Growth Resumes

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is currently running at about \$220 billion per year. The uncertainty is about when, which, and how much. Clearly the deficit will not go away—not with growth nor with any of the deficit reduction schemes being discussed in Washington.

## Outlook

The outlook is for continual but erratic economic growth in 1985. Real GNP is expected to grow 3.5 to 4 percent. Unemployment could fall a bit more, but that will happen much more gradually than in the past two years. We should go below 7 percent. Inflation may begin to creep up somewhat, but it should remain at 5 percent or under throughout the first half of this year.

Although the near term looks rosy for the national economy, the situation for Michigan is more uncertain. While a buoyant economy will support an even more buoyant automobile market, car production in Michigan will be held down as the Japanese increase the number of cars they sell in the U.S. market following our lifting of the "voluntary" import quotas on Japanese cars. While this will hurt the domestic auto industry and Michigan somewhat, it won't throw the state back into recession. And the American consumer will reap noticeable benefits.

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## Seidman School Management

# MEMO

The *Seidman School Management Memo* is published twice a year, in the spring and fall, and is sent to all contributors to and friends of the Seidman School of Business. Gifts from these sources enable the Seidman School to sponsor activities and programs designed to increase understanding of our economic system, facilitate exchanges of ideas between students, faculty, and businessmen, and support faculty research and professional development and, in general, enrich the business and academic communities. Persons interested in more information about the *Memo* or the published articles should contact Dr. Marvin G. DeVries, Dean, F. E. Seidman School of Business, Lake Huron Hall, Grand Valley State, Allendale, Michigan, 49401. Telephone 616-895-3271.