Contracting Ethiopian sesame farmers to cut transaction costs

Sesame is the most important oil seed export crop in Ethiopia and its contribution to foreign exchange earnings has increased over the years. It was the second export earning agricultural product in 2008 and Ethiopia is the sixth world producer in sesame seed. The area under sesame production has grown eightfold between 2002 and 2005. Our case study on sesame farming in Humera, the heart of sesame production in Ethiopia, shows that smallholder farmers can increase their benefits from the sesame crop by entering into contract farming arrangements with a firm. This brief identifies the changes in transaction costs that companies trading in sesame face if they modify their sourcing strategy from spot markets to contract farming.

Transaction costs for companies buying sesame at spot markets

Companies that purchased sesame at spot markets found that high moisture content and high impurity levels (sesame mixed with sand, reject sesame seeds, blends of different seed types, etc.) were major problems (Amare, 2009). The costs of cleaning and grading sesame were borne by the traders and exporters. Tefera (2010) quotes an example of an exporter who spent 7% of the fob price to clean the sesame from foreign matters. The problem of low quality and the associated costs to fix this may decrease Ethiopia's competitiveness.

Contract farming can decrease costs

Contract farming allows better performance measurement, as buyers and farmers make agreements on how and when to monitor product quality. Hence, companies can reduce the costs of controlling product quality. This is important because exporters face ever stricter product specifications (including quality, consistency, traceability and food safety).

Contract farming refers to pre-agreed supply agreements between farmers and buyers. Usually local farmers grow and deliver agricultural produce for specified quantity and quality at an agreed date. In exchange, the company agrees to buy the produce supplied, mostly at a specified price. Moreover, the company can provide upfront inputs, such as credit, seeds, fertilisers, pesticides and technical advice to the contract farmers, all of which may be charged against the final purchase price.

New transaction costs for sesame contracting firms

Contract farming, however, also entails several costs. In order to obtain sufficient amounts of quality supply, a company will have to contract a great number of farmers because yields and sesame production per household are low . Yet screening, communicating with, and coordinating a myriad of farmers is a complex task.

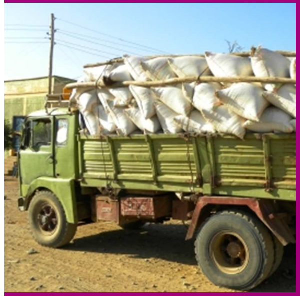
Yields are low as most sesame farmers in Humera lack access to skills, services and inputs. Because of the current imperfections in the Ethiopian input markets, the contracting firm will have to internalize most costs of credit, fertilizer and pesticides provision as well as other support services such as extension. In addition, establishing and monitoring contracts with many farmers entail considerable transaction costs. The table below gives an overview of the additional transaction costs that contracting firms may incur. The role of producer organisations in transaction costs is discussed below.

Contract farming only for high value sesame markets

Even when contracting firms have invested considerably in contract farmers, Ethiopian farmers may still sell their sesame to any of the many buyers available ("reneging" or "side-selling"), a common problem in Ethiopia. Since contractual enforcement is weak in Ethiopia, many companies have concluded that contract farming in sesame is only viable if they can offer a premium price to their contract farmers to keep this side-selling under control and to recover the additional costs companies incur when providing inputs. Paying a premium price was only possible when contracting firms sold to a high value market.

Can producer organisations help to reduce transaction costs in contract farming arrangements?

As an intermediary between farmers and the contracting firm, producer organisations can decrease transaction costs in several ways (see table below). For instance, by organising the provision of inputs to



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Main transaction costs (TC) borne by contracting firms at key stages of value chain

Value chain stage	Supply of inputs (for smallholder farmers)	Production	Trade and logistics (local)	Meeting client requirements
Contract farming without producer organisation	Provision inputs to large number of farmers => high TC Screening farmers => high TC	Communicating, training, monitoring many farmers => high TC	Firm needs to contract many farmers => high TC Farmers may renege on contract if offered higher price by others. Farmers have many marketing outlets => possible TC for companies	Performance criteria written in contract. Yet measurement of performance with many small farms => high TC
Contract farming with well-functioning Producer Organisation (PO)	POs can organise provision of inputs and credit to farmers => decrease TC PO better info on quality & reliability of producer => less contract default =>decrease TC	PO can assist with training and monitoring of farmers => diminish TC for contracting firm	PO can assist with collection, sorting, grading, sesame etc. Economies of scale in marketing => reduction TC	PO can assist with quality control => reduction TC

farmers, aggregating the outputs, resolving disputes.

Producer organisations can make contract farming more attractive for a company, however the membership of a cooperative brings a whole new set of transaction costs to farmers. The potential benefits and in particular the costs to farmers of joining a producer organisation are not always clear. Successful association requires management and entrepreneurial skills - 'soft' assets that many smallholders are less likely to have . Moreover, there are several transaction costs internal to the producer organisation: the time and effort needed to govern and manage the organization, for instance coordinating meetings among members, collecting their membership fees or other contributions, resolving conflicts and disputes and monitoring compliance with the organization's rules.

What are the experiences with Ethiopian producer organisations so far?

Most Ethiopian producer organisations are multipurpose cooperatives that market little agricultural produce, and are not very effective. The lack of qualified personnel limits the effectiveness of Ethiopian producer organisations. There are few cooperatives that currently do provide marketing services, are relatively well organized and that obtain improved prices for their members. Most of these cooperatives are located in Tigray and Amhara Regions, the main sesame producing areas in Ethiopia .

Contracting firms are often prepared to support the development of producers' organisations; for instance, through training, provision of inputs, pre-financing, etc. Nevertheless, these firms prefer to work with cooperatives that already have attained a certain level of 'doing good business'.

Hence, firms' interests to invest in contract farming arrangements with smallholders depends on two main factors. Firstly, whether they can sell the Ethiopian sesame to a premium market to be able to offer farmers a premium price and thus " tie" them to the contract. Secondly whether they can identify an efficient producer organisation to collaborate with to decrease transaction costs. Contract farming in Ethiopia is thus a viable option, but only under a strict set of conditions.

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