



## Farmers' marketing preferences in local coffee markets: Evidence from a choice experiment in Ethiopia



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### ABSTRACT

This study investigates transactions in the local coffee markets in Ethiopia. While the Ethiopian Commodity Exchange, which was established in 2008, introduced regulatory, institutional, and organizational innovations in the coffee market, informal norms and conventions remain the primary institutions governing transactions in the local markets. Based on a choice experiment, we found that for coffee farmers the characteristics of the traders are more important than the price offered when anchoring their transactions into personal relationships. This can be explained as the institutional response of farsighted calculative farmers to poorly organized coffee markets and to lacking credit and insurance markets. Contrary to the concept of embeddedness, which claims that economic transactions are embedded into social relationships, social relationships are observed to be embedded into economic relationships. One of the perverse effects of these personal relationship-based transactions is that farmers are insufficiently incentivized to maintain and improve coffee quality.

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### Introduction

Most economic transactions in sub-Saharan Africa take place within village/local spot markets (Fafchamps, 2004). In these markets very large numbers of sellers transact with many buyers. Each agent takes a very small share of the market. No formal entry barriers exist. At first sight these markets resemble the purely competitive markets described in neoclassical economics (Geertz, 1987). In the case of cereal and other agricultural markets, there are many buyers because households, local traders and service providers (such as restaurants) all compete in the markets. In the past, the political, infrastructural and institutional environment left most rural areas with narrow markets, confined to a small locality. As a result, the emphasis was to expand trading opportunities by reducing transportation costs and removing conventional trade barriers on agricultural commodities, such as taxes, bureaucratic licensing and entry barriers. The assumption was that the capacity of the market to incentivize the producers depends on the scope for profitable trading opportunities and the capacity of traders (especially in terms of access of trader to capital) to capture these

opportunities. So as long as trading opportunities were open and traders had competitive access to capital markets, farmers would receive the “right” price. It was in view of this that most non-market economies made a sweeping liberalization reform in the 1990s and 2000s.

But then it became clear that for small-scale producers to receive the “right” prices, more was needed than just removing legal barriers and improving infrastructure. If the costs of transactions at higher level remain so high as to block trade, then farmers will continue to receive the limited incentive offered by a narrow market. An implicit assumption in the liberalization reform was that transactions are costless. Institutional economics challenged this assumption and explicitly recognized the role of transaction costs in determining the gains from trade. Dissatisfied with the outcomes of the liberalizations reform, institutional economists convincingly showed the role of institutions in determining economic performance. Many suggested a policy shift from ‘getting prices right’ to ‘getting institutions right’ (World Bank, 2002; Fafchamps, 2004; Dorward et al., 2009). So infrastructural and technological improvements need to be accompanied by institutional interventions to help farmers to get the right incentives. The establishment of the Ethiopian Commodity Exchange (ECX) in 2008 can be considered as an institutional intervention to reduce the transaction costs constraining the agricultural markets (Gabre-Madhin and Goggin, 2005; Meijerink et al., 2014). Although

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the primary goal of the intervention was to benefit small-scale farmers (Gabre-Madhin, 2009), the intervention targets the central markets of export commodities. It is assumed that farmers will automatically capture gains from improvements at the central markets.

In this perspective it is relevant to understand the institutional environment governing the local markets. Recent evidence shows however that agricultural commodity exchanges in the region have thus far failed to develop into sustainable trading platforms and that even after their introduction informal institutions still govern the local markets (Sitko and Jayne, 2012; Meijerink et al., 2014). Transactions in the local markets remained personalized and confined to the narrow social circle connected by family lineage, acquaintance, kinship and patron-client relationships (Tadesse and Shively, 2013; Meijerink et al., 2014). It is important to get insight in the behavioral motives behind these personalized transactions and their implications for the performance of the value chain. There are two possible explanations. First, it is the result from traders colluding to share the market. For a few dozen of socially connected traders in a given district market, reaching and sustaining 'cartel' agreements may not be difficult. Furthermore the nature of the transaction may require traders to do so. This will leave farmers with monopsony buyers with whom it is rational to establish long term relationships. The other possibility is that in order to reduce transaction costs, farmers themselves choose to establish long term relationships with a specific trader. In that case, they are expected to consider not only price offered but also characteristics of the trader in their decision. For instance, choosing a trader simply on price may involve some costs if traders cheat during weighing. In this case, farmers may have to consider trustworthiness of buyer/trader. In addition, farmers sometimes may not be able to find a buyer. In this case, they may also consider, in addition to price, the reliability of the trader. Similarly, if some markets such as credit markets are missing, farmers may still prefer to establish a trade who provides some loan, economic support and the like. For these and other reasons, farmers may prefer to establish long term relationships with a trader to lower these transaction costs.

The primary objective of this paper is to analyze the factors behind the personalized transactions considering the case of coffee markets in Ethiopia. To do so the attributes of traders that are preferred by coffee selling farmers are identified. However, actual selling behavior might not entirely reflect these preferences because farmers might not have all options in terms of characteristics of traders. Therefore a Choice Experiment (CE) was conducted, which allowed to construct hypothetical choice situations. The results of the CE are then further assessed in relation to the reality on the ground. Special attention is given to the implications on the performance of the local markets with a particular emphasis on the way quality improvements and maintenance are incentivized. Several studies have looked at local markets and smallholder marketing decisions in Sub Saharan Africa for several agricultural commodities e.g. Barrett (2008) for cereals in eastern and southern Africa; Mather et al. (2013) for maize in eastern and southern Africa; Little et al. (2014) for livestock in Ethiopia and Olwande et al. (2015) for maize, kale and dairy in Kenya. To our knowledge, however this is the first study that systematically addresses the issue of personalized transactions which are characterizing most local agricultural markets of sub-Sahara African and other similar countries and which are constraining rural communities in these countries. We believe that the study will provide important insights for policy interventions to improve institutional contexts.

The remaining part of the paper is organized as follows. It starts with a brief review of theories surrounding informal institutions (norm-based constraints) facilitating economic transactions and describes the institutional context governing the local coffee

market in the study area. A description of the choice experiment conducted and the econometric models used to analyze the data is presented in the second part. The third part presents and discusses the results. The implications of the findings are summarized in the final part.

### Personalized transactions

Generally two perspectives can be identified on the role of personalized transactions: social-capital theories and new institutional economics. Social capital theory conceptualizes social relationships as important ingredients of economic relationships and assumes their effect on economic performance is positive; by definition they are considered as a form of 'capital'.

Social capital theorists view personalized relationships as an important input in facilitating and coordinating economic transactions. They hypothesize a causal link between social relationships and economic progress (Coleman, 1988; Putnam, 1993). If social relationships are defined as 'capital', their presence and denseness leads to better economic (and political) outcomes. This theory contends that individuals rapidly learn the benefit of reciprocity, loyalty, trustworthiness, reputation and commitment from past feedback. Dense social networks are thus considered as an important milieu where cooperative behaviors emerge and collective actions are coordinated. However, given the positive outcomes associated to social relationships in the social capital theory it is difficult to explain why societies like those in SSA, where these relationships are dominant, aren't performing better. According to Levien (2015) social capital theory attributes failures of such societies exclusively to external factors that constrain the well-functioning of social capital.

For social relationships to produce 'capital', a closed social structure that has continuity over time is required (Coleman, 1988). Such closed social structure provides the organizational structure and the social means to facilitate information exchange, to continuously observe behavioral conformities and to sanction deviations. In this way norms of trust and commitment are created (Granovetter, 1985; Ostrom, 2005; Coleman, 1988) and information, monitoring and enforcement costs are reduced (Greif, 1989; Stiglitz, 2002). It is clear that sustained interaction of people in a closed social system spontaneously produces informal institutions, but the outcome of this on the economy as a whole is less clear. Portes and Landolt (2000) for example identify important adverse effects of social capital: exclusion of outsiders, excess claims on group members, restriction on individual freedoms and downward levelling norms. Especially in non-market primitive societies, an institutional environment can be produced that severely impedes economic progress. Social relationships in such societies are formed based on ascriptive ties, often linked to fixed identity traits such as family lineage, ethnic/clan membership, or other socially assigned statuses (Arrow, 1972; Posner, 1980; Granovetter, 1985; Geertz, 1987; Levien, 2015). When the social ecosystem is dominated by such identity-based fragmented social structures, economic cooperation between the rival factions will be difficult and costly. Furthermore the beliefs and value system that emerges from such closed social system might consider wealth accumulation as an object of greed and work as a burden (Kebede, 1999) and, as Granovetter (1985) acknowledged, that suppresses the development of private properties. Under such system economic opportunities are limited rather than expanded (North, 1990; Posner, 1980). Social capital can also be thought as exclusive ownership of a key resource that provide its owner a monopolistic power. By excluding outsiders, network owners can earn monopoly profits. Actions that are considered as immoral in transactions within the network will be considered as natural and morally

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