Organic Farming Certification –
the Costs of Reducing Transaction Costs

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Abstract - Since 1991, the European Union regulates
the organic food market. By implementing the organic
regulation and the corresponding inspection and
certification system, organic markets were fostered,
but the financial costs and bureaucratic drift of this
system are controversial. Up to now, there exist only
very rough estimates of the overall burden of organic
producers, mostly considering only the cash costs and
neglecting opportunity costs of the certified entities,
which are likely to be of considerable magnitude. As a
first step in approximating the amount of these costs,
this paper uses the concept of Transaction Costs in
order to identify and structure the relevant cost
types. The quantification of this concept needs data
which will soon become available.¹

INTRODUCTION
Organic food products are credence goods
(Darby/Karny, 1973). This categorisation refers to
buyers’ information costs required to check a prod-
cuct’s quality. Organic quality is the result of a proc-
cess standard comparable to social or sustainability
standards. Reference is made to the production
process and therefore the adherence to the standard
cannot be tested on the product directly. Even after
buying and consuming an organic food product, one
cannot evaluate the good’s attributes in this respect.
Thus, the information costs on organic markets are
relatively high because monitoring the production
process is quite laborious and expensive. This results
in considerable transaction costs, the costs related
to the exchange of a good (Williamson, 1985).
Transaction costs can be reduced by implement-
ing an organic standard against which products are
inspected and certified. By the implementation of
such a certification system, the existence of the
organic market is assured and transaction costs are
lowered, but such a system induces substantial costs
again. An estimate on the organic certification ser-
dices share as part of producers’ total certification
burden amounts to 1.5% of organic retail turnover
(Rundgren, 2001). For the year 2006, this would
equal only cash-based costs around 200 Mio. € for
European organic producers’ certification.² The over-
all costs (cash-based and especially opportunity
costs) of organic certification are mentioned as a
major reason why organic farms are reconverted to
conventional (e.g. Laes et al., 2008).

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² Zentrale Markt- und Preisberichtsstelle (ZMP, 8.2.2008) reports
the turnover of the European organic market to be 14,6 billion € in
2006.

In order to prepare an estimation of the costs of
the organic certification system, this paper aims at
structuring and defining the different types of trans-
action costs specifically relevant to organic produc-
ers. The costs of organic certification shall then be
estimated on European level in the framework of the
project CERTCOST (Dabbert et al., 2008).³

METHODOLOGICAL APPROACH
First, a literature analysis of publications on transac-
tion cost measurement and the structure of the
costs of market exchange is performed. Second,
based on the results of the literature analysis and
the theoretical concepts of New Institutional Eco-
nomics, particularly Transaction Cost Economics, a
system of the costs connected to organic foods’
certification is developed by means of a heuristical
approach.

LITERATURE ANALYSIS
The concept of Transaction Cost Economics generally
is widely applied in different areas. Empirical appli-
cation in terms of exemplary breakdown or even
cost estimation, however, can rarely be found (Rich-
but comprehensive overview on the diverse utilisa-
tion of transaction cost measurements in different
economic fields.
Comparable studies to this paper and the goals of
the project CERTCOST are not known, neither in
regard to the level nor the sector of analysis. Fund-
damental workings in transaction cost economics are
discussed and interpreted in the textbook “Neue
Institionenökonomik” by Richter/Furubotn (2003).

TRANSACTION COSTS
Occurrence and types of Transaction Costs
The term transaction costs for this study will be
defined as the cost related to the exchange of an
organic food product not including the cost of the
good itself.⁴ Transaction costs occur in different
forms and with specific characteristics: they can
either be variable or fix, appear as cash relevant or
as opportunity costs. Basic categories of transaction
costs are market, managerial and political transac-
tion costs (Richter/Furubotn, 2003).

³ The EU funded project CERTCOST is starting autumn 2008 and will
be coordinated by the Institute for Farm Management of the Univer-
sität Hohenheim, Prof. Dr. Stephan Dabbert.
⁴ For the multitude of transaction costs’ definitions, please consult
Market Transaction Costs
The most important category for organic certification systems is market transaction costs. These are defined as costs of using the market as point of exchange. In general, four categories of market transaction costs are distinguished:

1. Search and information costs,
2. bargaining and decision costs,
3. supervision and enforcement costs and, finally,
4. costs for investments in social relations (Richter/Furubotn, 2003).

Political Transaction Costs
Any transaction, either intra-firm or market transaction, occurs in a well designed institutional system of a polity. Setting up, maintaining and changing this system is costly (Richter/Furubotn, 2003). A good and up-to-date example for a small fragment of these costs, are the public but also private resources spent in the process of revising EEC regulation no. 2092/91 and deciding on EEC regulation no. 834/2007 on organic production and labelling.

Managerial Transaction Costs
Managerial transaction costs represent the intra-firm costs related to the exchange of a good. At present, we assume that there is no difference in these costs between organic and conventional farms.

Transaction Costs of Organic Certification
Organic certification systems intend to lower market transaction costs by providing reliable certification. Pivotal is consumers’ trust in the organic quality when they shop organic. Therefore, market transaction costs related to the exchange of a good between a farmer or retailer and the consumer are considered most important. The specific costs of using the organic market will be structured in the following part from the viewpoint of a farmer.

Search and information costs
The farmer has to find a buyer and exchange information on the good, e.g. its quality, and the buyer, e.g. its credibility or its solvency. In this regard, there exists only a small difference in search and information costs between non-organic and organic markets. Specific for organic farming is the duty to follow changing requirements of standards. Since organic farmers’ possibilities using inputs like fertilisers are limited, search and information costs are assumed to be higher.

Bargaining and decision costs
This cost category is considered to be of similar magnitude in transactions of organic and non-organic products. These transactions most likely do not differ concerning the costs incurred.

Supervision and enforcement costs
The category of supervision and enforcement costs, however, are unique in the organic product case. A compulsory system of supervision and enforcement for the organic market, the inspection and certification system, has been designed and implemented by the EU organic regulation (EEC regulation no. 2092/91). This system ties up market access to ex-ante inspection and certification. Hereby, the duty of supervising organic quality is to a large extent transferred from the buyer to the seller. This differs from the usual classification of supervision costs in the literature as ex-post transaction costs.

In order to be certified organic, a farmer has e.g. to commission a certification body, to fulfill specific documentation requirements or to apply for an exception in case of need. These specific requirements add up to considerable costs, either cash-based (e.g. the certification fees) or opportunity costs (e.g. the utility gone for the time spent for documentation).

Costs for investments in social relations
These costs occur e.g. when meeting clients in order to foster relations and to build up a trustful relationship. In organic food production this is of special importance and one could assume these costs being higher than in non-organic systems.

Outlook
This paper outlines the structure of the transaction costs specific to organic farming certification and provides some first hypotheses on their relative importance. In the project CERTCOST, data on the transaction costs associated with the organic certification system will be collected. These data will be analysed following the conceptual breakdown outlined in this paper in order to get an idea of the costs next to certification fees that burden organic operators. The question how relevant this burden is, when deciding for or against organic food production can then be answered based on empirical evidence.

References