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10-8

# **The Coffee Crisis: Is Fair Trade the Solution?**

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## Executive Summary

Coffee is an important crop widely grown in the developing world. The economies of some countries, particularly those in Central America and parts of Africa, are highly dependent on coffee as a source of both national income and export earnings. About 25 million people, most of whom are small-scale farmers, rely on coffee for a living.

Smallholder coffee farmers once reaped abundant benefits from their crop. Cash from coffee sales financed schools, hospitals, infrastructure, and training for farmers. Coffee-producing regions were also associated with higher income levels, higher literacy rates, higher nutritional levels, and less political instability. But all these benefits have evaporated since the late 1990s, when the world coffee price slumped to unprecedented low levels. The collapse of coffee prices has led to a humanitarian crisis with devastating effects on coffee growers, communities, and countries.

In the absence of government intervention in the sector, a number of innovative approaches, most notably the Fair Trade movement, have been proposed to revive farmers' incomes from coffee production. The Fair Trade movement seeks to challenge historically unequal international market relations, transforming North–South trade into an avenue of producer empowerment and poverty alleviation. Recently the Fair Trade movement has been characterized by national labeling initiatives coordinated under the Fairtrade Labelling Organizations International (FLO). The FLO certification is designed to help coffee growers gain direct access to international markets at guaranteed premium prices.

Fair Trade has had some success, but it also raises a number of issues. First, there is substantial concern about how much growers can actually benefit from this scheme. Although studies have shown that a decent share of Fair Trade premiums do reach growers, a large portion still goes to companies' profits or to administrative costs of Fair Trade organizations. Second, it is questionable whether Fair Trade can be a long-term solution to the coffee crisis. The cause of the coffee crisis is over-supply, so the high prices Fair Trade offers induce farmers who would otherwise seek other

alternatives to stay in coffee production, exacerbating the current situation. Third, the Fair Trade practice itself may be an inefficient means of wealth reallocation, making it susceptible to criticism from economic grounds.

Recognizing that the current coffee market problems are complex, policy makers have twin objectives: to meet the short-term needs of poor farmers during the crisis and to find longer-term solutions to overproduction in the market. Obviously, the most effective long-term strategy to assist the majority of coffee growers is not to create a niche market, but to help them explore other potential sources of income and dismantle barriers to switching crops. Before such a long-term strategy can take effect, however, Fair Trade should continue to be pursued.

Your assignment is to design an international coffee agreement to solve the problems now facing the farmers. By accounting for the different parties involved—coffee-producing countries, coffee-consuming countries, and nongovernmental organizations (NGOs)—you are required to identify both challenges and opportunities in the negotiation process.

## Background

### The Importance of Coffee in Developing Economies

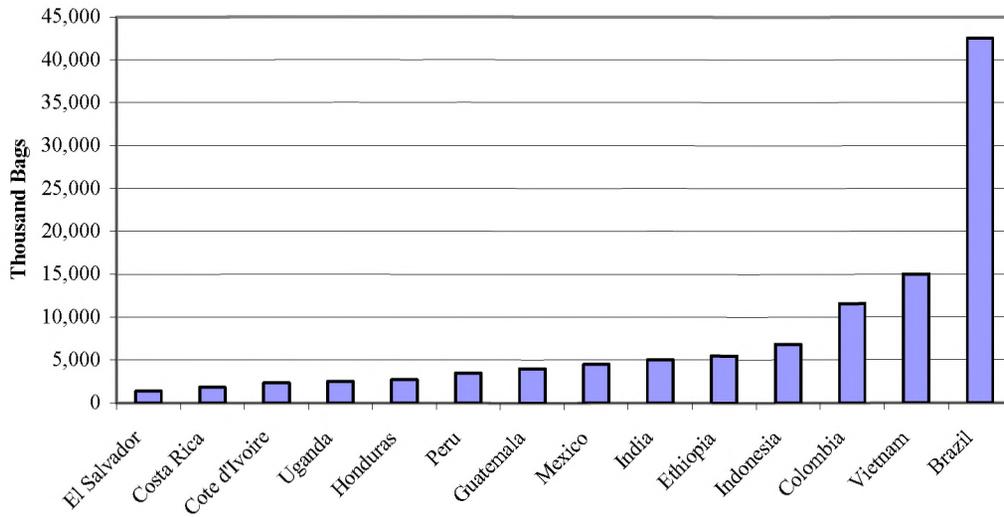
Coffee is one of the world's most important primary commodities, ranking second only to petroleum in terms of value traded worldwide. In 2003 total world coffee exports amounted to 90 million bags (60 kilograms/bag) worth US\$6 billion. Two major coffee varieties are found in the world market: Arabica, produced mainly in Latin America, and Robusta, produced mainly by Vietnam since the 1990s as well as by some African and Southeast Asian countries. Owing to its better quality, milder flavor, and more demanding cultivation, Arabica usually commands a higher price than Robusta.

Coffee is widely grown in the developing world. In 2006 more than 122 million bags were produced in more than 50 developing countries, including some

of the world's least-developed countries. Brazil is by far the largest coffee producer, followed by Vietnam, Colombia, and Indonesia (Figure 1). The economies of some countries, particularly in Africa and Central America, are highly dependent on coffee as a source of national income and export

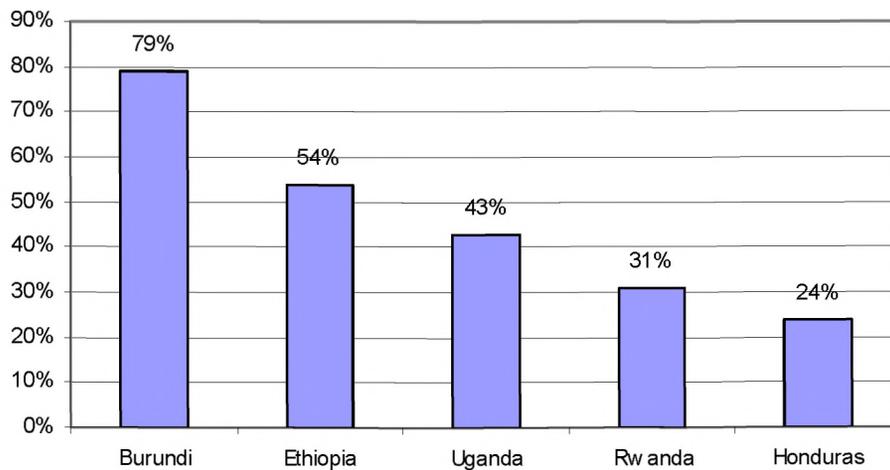
earnings. In Nicaragua, for example, coffee accounts for 7 percent of total gross domestic product (GDP). In Ethiopia, coffee accounts for more than 50 percent of export revenues, while in Burundi the figure is almost 80 percent (Figure 2).

*Figure 1: Major Coffee-Producing Countries, 2006*



Source: ICO 2007

*Figure 2: Percentage of Coffee Exports in Total Exports, 2006*



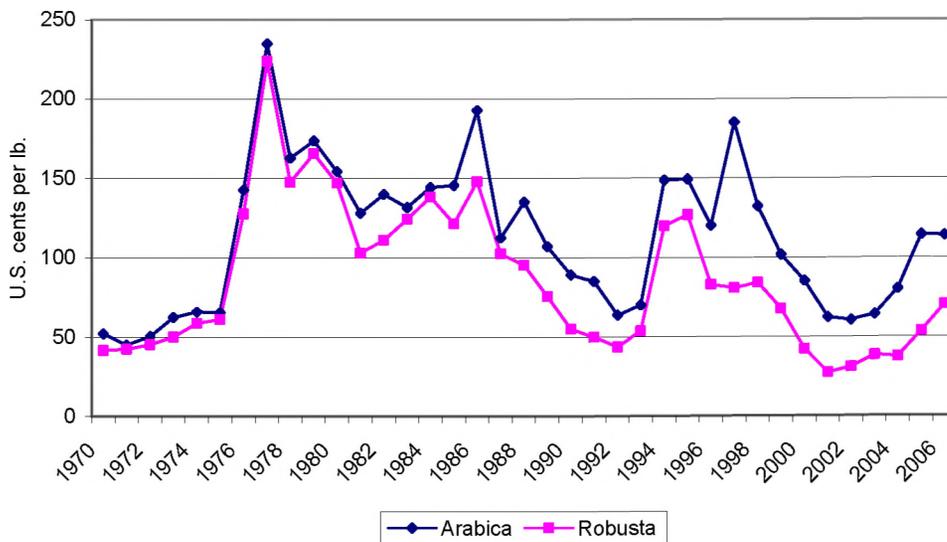
Source: ICO 2007

Coffee plays an essential role in the livelihoods of the world's poor—about 25 million people rely on coffee for a living. For instance, in Ethiopia, where the first coffee crop originated, more than 700,000 households are directly involved in coffee production. In Brazil, where almost a third of the world's coffee is produced, about 300,000 people are coffee farmers and a further 3 million are employed in the coffee industry. Unlike most other internationally traded commodities, coffee is still produced on smallholdings farmed by peasant households rather than on large plantations. About 70 percent of the world's coffee is grown on farms of less than 10 hectares, and of this share, the vast majority is grown on family plots of between 1 and 5 hectares (Oxfam 2002). Even in countries that do have large plantations, such as Brazil, India, and Kenya, there are many smallholder producers as well. For these small producers, coffee provides the main—and sometimes the only—source of cash income. Revenues from coffee are used to buy food items that cannot be produced on the farm, to pay for education and health care, and to meet other cash expenses, such as the purchase of agricultural inputs.

### The Coffee Crisis

In the past smallholder farmers reaped abundant benefits from their coffee crops. Cash from coffee sales financed schools, hospitals, infrastructure, and training for farmers. Coffee-producing regions were also associated with higher income levels, higher literacy rates, higher nutritional levels, and less political instability. All these benefits have evaporated since the late 1990s, when the world coffee price slumped to unprecedented low levels (Figure 3). According to the International Coffee Organization (ICO), average coffee prices for Arabica and Robusta were well above 100 U.S. cents per pound (lb.) from the mid-1970s to the late 1980s. The demise of the International Coffee Agreement (ICA) in 1989 marked the start of a long-term price decline. Apart from two sharp price spikes around 1995 and 1997, caused by the loss of the Brazilian crop to frost, coffee prices have dropped to the lowest levels recorded in the past 30 years (or the lowest in the past 100 years when adjusted for inflation). In 2001 prices touched their historical minimum of just 30 cents/lb. for Robusta and 60 cents/lb. for Arabica. Prices have recovered somewhat in recent years owing primarily to production slowdowns in Brazil and Vietnam.

Figure 3: Arabica and Robusta Prices (U.S. cents/lb.), 1970–2006



Source: ICO 2007

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The collapse of coffee prices has generated a humanitarian crisis with devastating effects on coffee growers, communities, and countries. Families dependent on money generated by coffee are pulling their children, particularly girls, out of school, undermining the next generation's prospects of escaping poverty. In some regions, hunger and malnutrition rates are on the rise as basic food and medicines become unaffordable. Desperate coffee farmers are forced to migrate to cities or to grow illicit crops such as coca. Beyond farming families, national economies are suffering. For example, countries in Central America saw revenue from coffee exports fall 44 percent in one year—from US\$1.7 billion in 1999/2000 to US\$938 million in 2000/2001 (Oxfam 2002). During the same period, Ethiopia's export revenue from coffee fell 42 percent, from US\$257 million to US\$149 million. Governments that rely on the export revenues from coffee are faced with dramatically declining budgets for education and health programs and reduced capability for debt repayment. For countries such as Burundi and Ethiopia, where coffee accounts for more than half of export earnings, the fall in world prices threatens to generate an acute balance of payment crisis. Some regions are on the verge of more serious humanitarian crises, similar to those that haunted Mexico and Rwanda during the early 1990s.<sup>1</sup>

### Causes of the Crisis

For most of the postwar period, trade in coffee was regulated by a series of International Coffee Agreements (ICAs). The ICA regime was an agreement among producing countries to restrict supply coupled with an agreement among consuming countries to keep prices high. In this period the coffee industry in most producing countries was regulated, with parastatal enterprises heavily involved in stabilizing prices and monitoring quotas. After 1989 a free-market move dominated the political agenda in many producing countries, and consuming countries no longer felt a Cold War justification for supporting producers. The ICAs dissolved in 1989, and by the 1990s many producing countries had partially or fully liberalized their coffee industries.

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<sup>1</sup> Some argue that the armed conflicts in Chiapas and Oaxaca in Mexico and the genocide in Rwanda are among the earlier episodes of the coffee crisis (see Halle et al. 2002).

Domestic liberalization has been accompanied by development agencies' strong efforts to promote production and exports, through project lending and wider macroeconomic reforms. For example, various development projects were instrumental in helping Vietnam start producing and exporting coffee. The country is now the world's second largest exporter of coffee. Similar projects have been undertaken in other countries. Since 1990, with the planting of new coffee trees, technological innovation, and the arrival of newcomers in the market, world coffee production has increased by 15 percent. World consumption, however, has increased by only half that rate, resulting in excess supply and accumulating stocks of more than 1 million metric tons in consumer countries.

There is little political support from coffee-producing countries to restore the pre-1989 regime by regulating their coffee supply, as evidenced by the failure of the recent Coffee Retention Plan (CRP) developed by the Association of Coffee Producing Countries (ACPC).<sup>2</sup> Indeed, production controls or export retentions may be beneficial in the long run if prices could recover to remunerative levels, but they could also be costly in the short run in terms of lost sales. Few countries would be willing to make an initial move so that all would gain eventually. An agreement becomes even less appealing when defaults or "free rider" issues arise. Major suppliers in East Asia, such as Indonesia and Vietnam, appear bent upon increasing their market share, regardless of world prices.

A lack of support from coffee-consuming countries has also contributed to the current crisis. Despite the mounting evidence that deregulation of coffee markets has led to an economic and social disaster for the poor, the rich world has resisted efforts to get the issue of commodity price management back onto the international agenda. Instead, they have adopted a "no intervention policy," not least because the crisis means good business for their politically powerful transnational companies.

### Fair Trade Certified Coffee

In the absence of government intervention in the sector, a number of innovative approaches, most

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<sup>2</sup> Under the CRP, initiated by Brazil and Colombia, exporters are requested to withhold 20 percent of their exports from the market.

notably Fair Trade coffee, have been proposed to revive coffee production.<sup>3</sup> Fair Trade coffee started as a part of a larger Fair Trade movement that dates back to the late 1940s when the Alternative Trade Organization (ATO) was established (see Moore 2004 for a general discussion of Fair Trade). In comparison with conventional trading structures, the ATO offered higher returns to producers of handicrafts and agricultural commodities in the developing world through direct trade and fair prices. From its ATO roots, Fair Trade has grown rapidly over the past two decades as a result of a labeling initiative introduced in the Netherlands in 1988. Although it has adopted some of the practices from the ATO, Fair Trade labeling has been designed as a market-based policy instrument to simultaneously achieve a variety of social goals related to health, the environment, social justice, and poverty. Fair Trade coffee labeling, in particular, aims to improve the livelihoods and well-being of small coffee producers by increasing their market access, strengthening their organizations, paying them a fair price, and providing continuity in trading relationships.

Central to the today's Fair Trade coffee movement is Fair Trade labeling. The first Fair Trade label in the Netherlands was named "Max Havelaar," after a fictional Dutch character who opposed the exploitation of coffee pickers in Dutch colonies. Other national labeling initiatives soon followed, some using the same name (Belgium, Denmark, France, Norway, and Switzerland), and others introducing new names, such as TransFair in Canada, Italy, and the United States, Fairtrade Foundation in the United Kingdom, and Rättvisemarkt in Sweden. In 1997, 17 national Fair Trade initiatives (now 20 countries) together founded an umbrella organization, the Fairtrade Labelling Organizations (FLO) International. Each country continues to use its own Fair Trade coffee logo in labeling, although an effort to harmonize the various national logos into one international certification mark is underway.

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<sup>3</sup> Fair Trade is one of three kinds of "sustainable" coffee schemes; the other two are organic and shade-grown coffee. Organic coffee is produced under strict certification guidelines and is grown without the use of potentially harmful artificial pesticides or fertilizers. Shade-grown coffee is produced in regions where natural shade (canopy trees) is used to shelter coffee plants during parts of the growing season.

Under the current Fair Trade labeling scheme, affixing a Fair Trade logo to their merchandise requires coffee roasters to purchase from Fair Trade-certified importers who (1) buy directly from FLO-approved grower organizations using purchasing agreements that extend beyond one harvest cycle; (2) guarantee the FLO minimum price, which might vary across coffee types and origins, pay an additional US\$0.15 per pound for coffee certified as organic, and pay a social premium valued at US\$0.05 per pound (Table 1);<sup>4</sup> and (3) offer pre-financing up to 60 percent of the contract value. To be included on the FLO's approved registry of Fair Trade coffee growers, producers must (1) be small, family-based operations; (2) be organized into politically independent democratic cooperatives; and (3) pursue ecological goals and conserve natural resources.

## Stakeholders

### Consumers

Consumers and their sense of social obligation are the backbone of the Fair Trade coffee. The penetration of the Fair Trade movement into the Northern market (for coffee and various other commodities such as bananas, tea, chocolate, honey, and sugar) are supported by Northern consumers' heightened concerns over global ethics and the rise of "ethical consumption" practices where the social relations embodied in particular commodities increasingly shape product choices. Fair Trade coffee addresses such ethical concerns, assuring consumers that buying the product guarantees a better deal for the Southern producers. The consumption of Fair Trade coffee thus offers an important opportunity for consumers to identify themselves as socially conscious individuals. By building a new civic and domestic convention within Fair Trade networks through their purchases and consumption, consumers individually can challenge the old business norms and practices that have so far shaped the mainstream trade regime. Increasing consumer involvement in Fair Trade may also form a collective bargaining power, which can either presses corporations to enter Fair Trade networks or seek changes in North-South relations more generally.

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<sup>4</sup> When world coffee prices rise above the guaranteed minimum, importers must pay US\$0.05 per pound above the world market price.

Table 1: Guaranteed Prices for FLO-Certified Fair Trade Coffee (U.S. cents/lb.)

Type of coffee	Regular		Certified Organic	
	Region I	Region II	Region I	Region II
Washed Arabica	126	124	141	139
Nonwashed Arabica	120	120	135	135
Washed Robusta	110	110	125	125
Nonwashed Robusta	106	106	121	121

Note: Region I is Central America, Mexico, Africa, and Asia. Region II is South America and the Caribbean.

Source: FLO 2006

### Farmers, Cooperatives, and Rural Communities

Currently, 221 coffee grower cooperatives represent 800,000 small-scale growers in 24 of the world's major coffee-exporting countries in Africa, Asia, and Latin America (TransFair USA 2006). The most important impact of Fair Trade has been on the lives of these smaller farmers, who in recent years have been able to sell their coffee at prices that are significantly higher than those in conventional markets. The FLO, calculating the difference between the ICO average indicator price and the Fair Trade price, shows that producers earned an extra US\$22 million by selling Fair Trade coffee in 2003 alone (FLO 2006). One cooperative in Ethiopia reported that the coffee sold through Fair Trade gave its farmers 70 percent of the export price, compared with only 30 percent if sold in the open market. In Oaxaca, Mexico, coffee producers estimate that they more than doubled their sales revenue by selling through Fair Trade channels instead of traditional ones. For many small-scale coffee growers, the price premiums they can get have meant the difference between survival and bankruptcy. Higher prices have improved their living conditions and enabled them to meet their basic needs.

The indirect benefits through farmer cooperatives may be even more important. Fair Trade labeling organizations require that producers be collectively organized to facilitate the export capacity of small-scale growers and empower these associations as an instrument for the social and economic development of the members. FLO requirements that decisions regarding the investment of the Fair Trade social premium (US\$0.05 per pound) be made democratically can support collective practices within producer cooperatives. Many cooperatives invest this money in coffee infrastructure, including

quality improvements, quality controls, organic conversion, warehouses, and processing facilities, as well as in community projects including schools, sanitation, and health services. They also provide opportunities for economic independence and community involvement for women.

Although the outspoken motive of Fair Trade is to support individual farmers and their communities, also imbedded in its philosophy is environmental conservation and sustainable agriculture. Currently, more than 80 percent of Fair Trade coffee is organic, in contrast with regular coffee, which uses fertilizers and pesticides, including DDT, that then contaminate local watersheds and can harm the health of workers. Regular coffee grown on large plantations can also cause erosion, deforestation, and loss of biodiversity. Fair Trade farmers, however, are required to abide by certain ecological requirements and to conserve natural resources.

### Roasters and Distributors

Coffee roasters and distributors and their brand names can greatly influence product specification and consumer demand in the market place. Despite their potentially divergent commercial objectives, coffee roasters and distributors and their public name recognition and associated quality conventions can be used to promote Fair Trade. Recognizing this, Fair Trade labeling groups have attempted to enroll roasters and distributors and apply Fair Trade labels to their already branded corporate products in an effort to extend coffee sales within conventional retail channels. According to TransFair USA, roasters and distributors are the key link in the value chain for Fair Trade because they can determine the types of green coffee they sell and have the highest profit margin in the value chain to absorb the costs associated with Fair Trade (TransFair USA 2006).

Fair Trade coffee may turn out to be profitable for roasters and distributors as consumer demand for socially responsible goods, including Fair Trade coffee, is rising. Survey studies show that 81 percent of Americans are willing to switch brands to help support a cause when price and quality are equal, and 63 million consumers base their purchasing decisions on how the products they consume affect the world (TransFair USA 2006). Some retailers have noticed this market trend and created corporate programs in order to ensure consumers of their commitments to a greater social responsibility in addition to their search for profit. There are even companies whose very profits are based on their marketing of social responsibility and ethical consumption. For coffee roasters and distributors in general, incorporating a recognized code of social responsibility can at least gain some advantage by promoting a positive product image to consumers.

Getting roasters and distributors involved in the Fair Trade movement, however, has been an uneven process. When labeling was first initiated, small socially conscious coffee retailers and roasters who had long been buying directly from producers moved easily into Fair Trade networks and helped develop and maintain them. Mainstream roasters are much slower and more reluctant to participate owing to conventional industrial concerns over brand quality, standardization, and efficiency.

### Fair Trade Organizations

The Fair Trade labeling organizations, including the FLO and its members, are not directly involved in coffee production or trade. Instead they seek to promote the market for Fair Trade coffee by working with coffee grower cooperatives, importers, roasters/wholesalers, and retailers. Coffee roasters and distributors may buy a license to display the Fair Trade logo on specific packages of coffee if they purchase from cooperative groups that are on the FLO coffee register and uphold FLO standards and procedures. Unlike other certification schemes, like the ecolabeling of organic food and sustainable forest products, which focuses strictly on conditions at the point of production, Fair Trade's certification criteria cover both trade and production conditions. The FLO constantly monitors growers and their cooperative groups and maintains the producer registry, while national labeling organizations keep track of licensing,

monitoring, and collecting fees from imports, roasters, and distributors.

## **Policy Issues**

### How Much Can Farmers Benefit from Fair Trade?

A frequently asked question about Fair Trade coffee is how much of the retail price premium actually reaches the growers. Although many consumers believe that farmers are significantly better off because of the higher prices they get, a study by Mendoza (2000) has shown the opposite. Mendoza measured prices along the supply chain for instant coffee produced in Nicaragua and sold in the United Kingdom in 1996. His results suggest that farmers received a premium of only US\$0.09 per pound, or 2 percent of the US\$4.23 retail premium. The UK distribution system absorbed the largest single fraction of the retail premium—US\$1.54, or 36 percent. Since the Mendoza study uses data from 1996, the results may well underestimate current Fair Trade benefits for farmers, since the world coffee price was then much closer to the guaranteed Fair Trade price and the marketing margins were much larger.

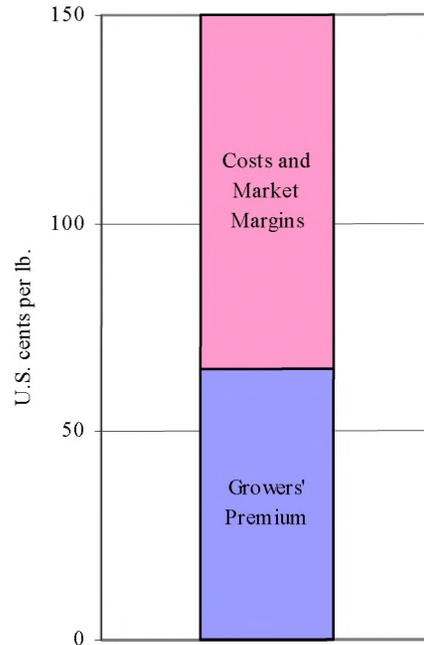
Zehner (2002) assesses the distribution of the Fair Trade retail price premium for one pound of roasted mild Arabica coffee sold in the United States in 2002 (Figure 4). Based on the 2002 world market price of US\$0.59 per pound of Arabica coffee, Zehner shows that the FOB (free on board) price premium paid to a cooperative was US\$0.67 per pound of green coffee (US\$1.26 less US\$0.59), or US\$0.80 per pound of roasted coffee.<sup>5</sup> Assuming a cooperative retains US\$0.13 of the US\$1.26 it receives per pound of green coffee, or US\$0.15 per pound of roasted coffee, farmers would eventually get US\$0.54 for each pound of green coffee they sell (US\$0.65 per roasted pound).<sup>6</sup> Using a retail price premium of US\$1.50 (roasted pound) that existed for Starbucks Fair Trade Blend over its House Blend, Zehner shows that about 43 percent

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<sup>5</sup> This is based on a conversion rate of 1.2 between green coffee and roasted coffee.

<sup>6</sup> Transfair USA allows cooperatives to retain a maximum of US\$0.26 of the US\$1.26 they receive per pound of green coffee. Zehner (2002) optimistically assumes that the cooperatives only retain half of that maximum—US\$0.13 per green pound.

Figure 4: The Distribution of the FairTrade Premium in the United States, 2002



Source: Zehner 2002 and author's calculations

(65 cents out of 150) of the retail premium could be passed on to coffee growers. The rest of the premium goes to Fair Trade licensing, distribution, and processing margins, and taxes and other costs incurred in the producing country. Since the Fair Trade price to growers is fixed (US\$1.26), changes in the costs and profit margins along the supply chain will affect the retail premium (that is, pushing it above or below US\$1.50) and the percentage of that premium that growers receive.

From Zehner's calculations, it seems that a significant share of Fair Trade premium does reach the growers. There remains an important question, however, about whether the Fair Trade scheme is a more desirable method of transferring income from consumers to growers than a direct-transfer program. A large share of the retail price premium in Fair Trade still ends up either as companies' profits or as administrative costs associated with Fair Trade organizations.<sup>7</sup> Clearly, a socially

conscious consumer would add more to growers' income by writing a check for US\$1.50 than by buying a pound of Fair Trade coffee. Yet it is unclear whether consumers would psychologically favor donating directly over paying a price premium.

#### Is Fair Trade a Viable Solution for the Long Run?

From an economic perspective, the high prices Fair Trade offers would work as a "price floor" leading farmers who would otherwise seek alternatives to stay in coffee production. This might not be a problem if the availability of the Fair Trade premium were guaranteed in the long run. But for most growers it would be a mistake to make this assumption since Fair Trade is likely to remain a niche, and not a mainstream, market. Despite strong growth in recent years, the market share for Fair Trade coffee is still very small (less than 5 percent on average). Given that a number of surveys

<sup>7</sup> For example, TransFair USA, a 40-employee organization, spent US\$1.7 million on its salaries, travel,

conferences, and publications in 2005 (TransFair USA 2006).

have shown that the percentage of consumers who are willing to pay more for ethical products is fairly high, this share reveals a clear gap between consumers' attitudes toward ethical products and their actual behavior in the marketplace (Pelsmacker et al. 2003). In the coffee market, as in most other product markets, the majority of consumers make consumption decisions according to product attributes such as price, quality, convenience, and brand familiarity rather than the ethical contents.

This implies that supply of Fair Trade coffee will continue to exceed its demand. One possible result is that the Fair Trade premium will fall: if too many producers try to move into this segment of the market, it would cease to be a niche capable of commanding high prices. Another possibility is that the premium will stabilize at some point and the opportunity to sell in the Fair Trade channel will be rationed, which has already occurred. Currently not all poor producers can move into the Fair Trade coffee market, and those who can only sell a certain percentage of their total output. TransFair USA reports that its growers sell an average of only 15 percent of their monthly output to Fair Trade buyers. Whether the premium falls or rationing occurs, simply supporting producers in the Fair Trade market cannot be a solution to the systemic problems affecting millions of farmers. The problem of everyone squeezing into the same niche that is perceived to be profitable—known as “the fallacy of composition”—has been a common phenomenon in commodity production for decades.<sup>8</sup>

### Is Fair Trade Economically Efficient?

The idea of helping developing countries by paying higher prices for their products may have a certain intuitive appeal, but if one looks beyond the direct income transfer effect, it is far from evident that this practice is a globally desirable one.<sup>9</sup> In economics, a market transaction sometimes leads to an

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<sup>8</sup>A fallacy of composition arises when one infers that something is true of the whole from the fact that it is true of some (or even every) part of the whole. For example, increasing saving may be good for an individual, but if everyone saves more, it may become a bad thing for the whole economy since it will cause a recession by reducing consumer demand.

<sup>9</sup> The discussion here focuses only on pure economic aspects of fair trade, ignoring its impacts on environment or health.

unequal distribution of wealth, owing to initial differences in individuals' endowments. This outcome, however, may be Pareto optimal (efficient) in the sense that no one can become better off without making someone else worse off. Redistributive efforts aimed at addressing the inequality can enhance equity on the one hand and lead to a decline in economic efficiency on the other. A reallocation of income distorts an otherwise more efficient market outcome despite the fact that it is morally attractive. Maseland and Vaal (2002) show that under certain circumstances, Fair Trade can be inferior to either free trade or even no trade in terms of efficiency. But there is always a debate on the trade-off between equity and efficiency, and each society must decide whether it is willing to increase equity by accepting some inefficiency.

The efficiency loss can also result from the exclusion of middlemen from the Fair Trade transactions. Bypassing middlemen, according to Fair Trade supporters, would reduce the leakage of benefits along the supply chain, allowing farmers to get higher prices for the coffee beans they sell. This argument ignores, however, a basic economic rationale that supports the very existence of middlemen: information asymmetry. It is well known that the coffee market is characterized by a fragmented supply base and unobservable quality. Without middlemen, who are usually very efficient in assessing coffee quality across suppliers, Fair Trade coffee buyers may face a higher information cost to search for and compare quality themselves.<sup>10</sup> When this information cost gets sufficiently high, buyers may stop searching and become “locked in” to a relatively small number of sellers whose quality may be unknown. This group of coffee growers, perceiving that the buyers are less able to access their quality information, would face a situation of “moral hazard” and would choose to sell their poorest-quality beans through the Fair Trade channel while reserving the best-quality beans for the traditional channel. Under these circumstances, an inefficient market equilibrium would result, which could eventually lead to the collapse of the Fair Trade market.

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<sup>10</sup> There may be a counterargument that the existence of a small number of middlemen may in fact block information flow and cause market inefficiency.

## Policy Options

Current problems in the coffee market are complex, and an integrated strategy is required. Policy options should meet the short-term needs of poor farmers as they attempt to ride out the crisis and address longer-term solutions to overproduction in the market. The most effective long-term strategy to assist the majority of growers might be to explore other potential sources of income and to dismantle barriers to switching crops. Before that long-term goal can be achieved, however, Fair Trade should continue to be pursued.

### Building Social Responsibility and Consumer Trust

To enhance the performance of Fair Trade, it is important to create a large and sustainable consumer base. Since people generally make their purchasing decisions based on price and quality, Fair Trade organizations need to add a “social responsibility” dimension to coffee and incite consumer demand for it. They can do so by raising public awareness of Fair Trade issues through educational and mass media campaigns—a strategy that has been very successful in several European markets. In addition to influencing individual consumers’ purchases, this strategy can be used to convince large buyers to switch to Fair Trade products. Institutional buyers such as government offices, hospitals, colleges, airlines, and company cafeterias can all have a significant impact on the market for Fair Trade coffee. In an institutional setting, individual consumers need not make a decision about how to “vote” with their money on ethical products, as the decision has already been made for them (Levi and Linton 2003).

Consumer trust in Fair Trade operations is also crucial for strengthening the Fair Trade coffee market (Raynolds 2002). No matter how charitable customers are, if they do not believe the premium they pay will help poor farmers, they will refuse to purchase Fair Trade coffee. Because the processes of international trade are relatively abstract and hidden from potential customers, this trust must likely be based on the existing commercial relationship between the retailer and the customer and, more important, trust in the Fair Trade organizations’ labels. The relationship between the retailer and the customer could be a source of problems if it appears that too much of the premium ends up

in profits. For example, a farmer is guaranteed to receive US\$1.26 per pound for his or her coffee from Fair Trade, whether consumers pay US\$5 or US\$10 per pound for that coffee. Fair Trade organizations can help maintain the trust by keeping Fair Trade operations transparent and by ensuring that their certifications are not misused.

### Mainstreaming

Mainstreaming Fair Trade coffee by targeting roasters and retailers may help expand the current Fair Trade consumer base. The roasters and retailers targeted could be those that already have a commitment to corporate social responsibility and those most open to adopting such principles. By indirectly highlighting the fact that farmers supplying the mainstream market are paid prices that do not even cover production costs, Fair Trade can successfully pose a serious reputation risk to coffee firms whose products are susceptible to consumer sensibilities. Experience in the United States has shown that some, especially small retailers and specialty coffee sellers, have been very quick to respond by expanding their Fair Trade sales. Others roasters and retailers have adjusted slowly. A few objected strongly to the term “Fair Trade coffee” since they perceived that it could imply other coffee was traded “unfairly.” For various reasons, including a fear of losing a growing number of socially conscious consumers, some reluctant companies have subsequently changed their attitudes and started to purchase a certain percentage of their coffee from Fair Trade producers. For example, facing the potential threat to its public image, Starbucks ambivalently allocated 4 percent of its total purchases to Fair Trade coffee in 2004. The amount was more than doubled in 2005.

Transnational roasters are the slowest to adopt Fair Trade coffee, although they are the most vital in expanding this market. As powerful economic actors linking consumers in the rich world to poor producers, transnational companies could effectively enlarge the Fair Trade coffee market share through their existing marketing schemes. By doing so, however, they risk the high profit margins they currently enjoy from traditional coffee channels. So far, the four biggest coffee roasters—Kraft, Nestlé, Procter & Gamble, and Sara Lee—have played no significant role in Fair Trade since they all fear that demand for Fair Trade coffee is too limited to justify adoption. Public pressure revolving around a

greater sense of social responsibility is thus critical in shaping the engagement of these companies in Fair Trade movement.

### Limiting Supply

Beyond Fair Trade, an obvious solution to the crisis is to bring supply back in line with demand and to stabilize prices at more remunerative levels. This solution would require a combination of stock destruction, production control, and export retention by all coffee-producing countries. But recognizing the fact that there have been no effective supply management programs since the demise of the International Coffee Agreement (ICA) in 1989, such a collective action should be built on a reconstruction of mutual trust between producer countries and a secured financial support from consumer countries.

Oxfam calls upon an emergency measure that would destruct a proportion of the lowest-quality coffee (about 5 million bags) currently held as stocks in importing countries. A reduction in stocks would send an immediate signal to the market and lead to a estimated price increase of 20 percent over the 2000/01 average prices, providing between US\$700 million and US\$800 million in additional export income for coffee-producing countries (Oxfam 2002).<sup>11</sup> The destruction would cost approximately US\$100 million. Possible financing of this action would have to be negotiated between the governments and companies involved. In addition to stock destruction, a retention of a portion of world coffee exports should be implemented. To facilitate the implementation of export retention programs, governments and donor agencies should terminate current policies favoring the expansion of coffee production, such as subsidies for land clearing, fertilizer use, and the introduction of higher-yielding hybrid trees.

### Diversification

National policies and donor assistance should provide better support, in terms of credit, technical assistance, and market information, to allow small coffee farmers to diversify into other crops or into nonagricultural activities. Diversification is not

simple issue as there are millions of coffee farmers and each one's situation is unique. Only when farmers themselves make the main decisions and when all resource implications for them are realistic would diversification be successful (Oxfam 2002). Information about which alternatives to coffee best suit local soils, climates, and market possibilities should be made readily available to the farmers who intend to switch crops. Extension advice about growing crops they are unfamiliar with and about marketing arrangements to help them get the best prices are also needed. Diversification for coffee farmers is likeliest to succeed when it is allied to broader national programs of agricultural diversification.

Moving out of coffee production is difficult because many potential alternatives (like cotton and sugar) are effectively ruled out as planting options. Current World Trade Organization (WTO) rules on agriculture fail to constrain rich countries from dumping subsidized farm produce on world markets, and thus restrict the markets for crops that farmers might use to diversify away from coffee production. New WTO rules may not be sufficient to solve the problem, but they do offer some hope for countries to diversify. No new rules are possible, however, without a commitment from developed countries at the Doha Round to remove both direct and indirect domestic and export subsidies on agricultural products and to ensure that farmers in developing countries have sufficient market access for diversification crops.

### Empowering Farmers

To accompany efforts to limit supply, coffee-producing countries must enact measures to enhance the power of farmers who manage to stay in the coffee market. One way to do this is by building basic market infrastructure and providing market intelligence. Small farmers in remote areas of poor countries are not well placed to observe international market situations and are in a weak position next to traders who have that information. It is often difficult for farmers to question a price offer and to negotiate effectively, putting them in the position of price takers. Telephone, radio, and Internet are all possible ways of transmitting this information to farmers. In addition, extension advice can enhance farmers' position in the market by providing them with technical information about harvesting and tending of crops and advice

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<sup>11</sup> To avoid prices fall below remunerative levels in the future, a longer-term strategy of contingency stock disposal should also be pursued (Oxfam 2002).

about market opportunities (Oxfam 2002). Finally, more and easier access to credit and inputs should be provided to farmers so that they can rely less on traders for financing.

### Improving Quality

Improving quality is central to restoring value to the coffee bean and the most significant international effort addressing the issue is the ICO's Quality Improvement Program (QIP). This program aims to stop the export of coffee below a certain quality and was welcomed by major coffee exporting countries. In order for the QIP to be successful, individual farmer's role in improving quality should be emphasized. Small farmers are believed to have better potential to produce good-quality coffee because they are more careful about picking ripe cherries than the operators of larger, mechanized plantations. But small farmers also need help with further quality improvement. Meanwhile, they need a mechanism that would reward them for the quality products they produce. To be most effective, a quality enhancement scheme needs to ensure that technical support is given to the poor producers and a grading system is available. It should also be accompanied by a disposal program for lower-quality coffee that is ineligible for export. For countries with very limited internal markets, external support is needed to absorb this coffee.

Another way of improving quality is to address the information asymmetry by reestablishing the link between growers and middlemen. With efficient mediation by middlemen, growers would have a greater incentive to increase quality because they would be rewarded for the better-quality coffee they produce. Fair Trade buyers, on the other hand, would have a greater incentive to pay higher prices if higher quality were guaranteed. If overall market efficiency is restored, the price increase as result of quality improvement could offset the costs associated with the middlemen's operations, leading to a net gain for the whole system and for the growers. It is important that middlemen operate in a competitive manner through market regulations, otherwise a power imbalance in the coffee supply chain will be reintroduced, with the efficiency gains winding up solely in the pockets of the middlemen.

### Assignment

Your assignment is to design an international coffee agreement for the purpose of solving the problems now facing coffee farmers. By representing different parties involved—coffee-producing countries, coffee-consuming countries, and NGOs—you are required to identify both the challenges and the opportunities in the negotiation process.

### Additional Readings

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