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**The Fair Trade Response to the Coffee Crisis. Achievements, Limitations and Prospects  
of a Voluntary Certification Scheme**

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## Appendix

## **1. Introduction**

The world price for coffee is currently at its lowest level in 100 years. For more than thirty years the coffee market has been regulated by the International Coffee Agreement (ICA) through which governments in both producing and consuming countries sought to agree on pre-determined supply levels and set export quotas for producing countries among other measures. The aim was to keep the price of coffee relatively high and stable, within a price band ranging from \$1.20/lb to \$1.40/lb (price per pound of Arabica coffee). Since the effective collapse of the ICA in 1989, massive and chronic over-supply of coffee has caused international prices to fall and be extremely volatile, making the livelihoods of small-scale coffee producers difficult and unpredictable. In some years, the international coffee price has been too low to allow small-scale coffee farmers to cover their production costs and many have had to abandon their land or could not take appropriate care of their plots anymore. The perception of a large-scale social crisis that was reflected by reports of numerous cases of human hardship in many coffee-producing countries has given strong impetus to the Fair Trade movement which has arisen from so-called Alternative Trade Organizations (ATO) that until the end of the 1980s operated mainly through World Shops based on voluntary work. With the beginning of the 90s, the perceived governance gap left behind by the collapse of government intervention has been attempted to be filled with voluntary "sustainable" certification schemes like Fair Trade labeled coffee.

The movement is now very complex and diverse which makes any categorization and generalization difficult and contestable. Furthermore, the notion of "fairness" can be confusing since it has previously been used in the context of protectionist attempts by interest groups in industrialized countries to exclude products from trade that had been produced more cheaply in developing countries due to lower production costs associated with less stringent domestic environmental or labor regulation. Creating fairness was therefore related to raising

the prices of these products through tariffs or import quotas to create a level playing field. Other traditional meanings of "fairness" relate to consumer protection through competition policy. In contrast, the Fair Trade movement examined in this study attempts to redress income differences between industrialized and developing countries through trade and assumes a moral obligation for consumers to pay higher prices for products that have been produced under certain defined conditions in developing countries. The case for Fair Trade can crudely be categorized into two sets of arguments: The first relates to fairness in its methods, targeting the conditions under which trade and production take place (refusing child labor, practices that degrade the environment, harm the dignity of producers etc.). The second argument is concerned with the consequences of trade and rejects efficiency as the main criterion to judge its outcomes, which are judged as unjustified if they are starkly unequal. In short, trade ought to be beneficial to the poorest segments of society. (Maseland and de Vaal 2002). FINE, a group of umbrella bodies and network organizations, has defined Fair Trade as "a trading partnership with aims at sustainable development for excluded and disadvantaged producers" (quoted in IIED 2000)

The aim of this study is to determine how effective the Fair Trade system in the case of coffee is at achieving its own goals which are concerned with absolute poverty reduction as well as with social justice understood as redistribution of wealth from the rich to the poor. Its analysis of trade relations in coffee emphasizes the simultaneity of a decline in world prices of unprocessed coffee for producing countries and of increasing retail prices in consuming countries, concluding on high profits made by the coffee industry in the rich world while peasants suffer. The Fair Trade label is supposed to restore this imbalance by shifting some of the profits from the first level to the second, without affecting end product prices significantly. Due to this dual goal of the movement, both absolute benefits accruing to small-scale coffee growers and relative gains from the retail price as expressed in the share of revenue will have to be examined. For this task, a supply chain analysis in the relevant domestic

and international markets appears to be the most promising framework. A macro-micro framework is necessary to neither downplay the role of larger forces that shape socio-economic change and policy-making nor ignoring local differentiation of production and trade processes. Fair Trade is not only a movement based on a critique of conventional trade practices and policies which it seeks to transform but also a business initiative which attempts to operate sustainably within this same environment. Consequently, its cost effectiveness and financial sustainability will also have to be analyzed. Fair Trade organizations and firms are market participants that try to challenge conventional profit-oriented companies by outcompeting them and by creating sustainable businesses. The aim of this endeavour is to ultimately induce a change to mainstream business practices in favor of producers also outside of the Fair Trade system itself, ideally with major companies behaving in an ATO like manner and guaranteeing decent trade conditions and prices to farmers. A third criterion against which Fair Trade has to be evaluated is therefore the extent to which Fair Trade has had an impact on conventional practices and in extension on the well-being of poor producers more broadly.

The effectiveness of Fair Trade as a developmental and redistributive tool can only be assessed against the background of characteristics and developments of the coffee market and its production and trade structures in general which will be examined in section two. To gain a better understanding of the functioning of the Fair Trade mechanism on the micro level and of the absolute improvements for small-scale producers, section three consists of a cost-benefit analysis for one participating community. In section four, the redistributive impact of Fair Trade within its own system shall be examined as well as its repercussions on conventional market players. Section five outlines potential growth perspectives of Fair Trade under different strategies for the future. Section six will conclude the previous findings.

## **2. Coffee production and trade**

Two coffee species which are traded separately on different markets are commercially relevant: Arabica, produced mainly in Latin America and regarded as higher quality coffee and Robusta, produced mainly by Vietnam since the 1990s as well as by some African and South-East Asian countries. Primary processing, the end product of which is green coffee which is traded internationally, takes place in the producer countries in the form of either dry-processing or wet-processing and is a key determinant of coffee quality. In the wet method, the coffee cherries are harvested, fermented and washed, dried, peeled and polished. In the dry process the whole cherry is dried until the green bean inside separates from the outer layers which must be removed by hulling later (Ponte 2001). The end result of the wet method is "Mild" or "washed" Arabica whereas the one of the more straight-forward dry method is "Hard" coffee, either Arabica ("Brazilian Naturals") or Robusta. Within the Mild Arabica category, a distinction is further made between "Columbian Milds", produced mainly by Columbia, Kenya and Tanzania and "Other Milds", which are predominantly produced in Latin American countries. The farmer sells the dried bean encased in a light skin or parchment (hence the name parchment coffee) on to a local trader who transports the coffee to a curing factory where the parchment is removed and the beans are sorted. They are then passed on to an exporter who pays the so-called "fob" (free of board) price and also takes care of grading, packaging and transporting. The green coffee is then shipped to the importing country, landing at "cif prices". Most international coffee trade consists of green coffee packed in 60-kg bags which is available to buyers either directly from its origin or via spot markets in the US and Europe. In the conventional market where coffee is sold as a commodity through spot and futures markets, the beans that arrive at buying stations are graded and classified in bulk lots where the production of many individual growers is mixed together. The processors at buying stations that own better grading equipment can unsort this mix and sell individual

components at higher total value than the mix. Since it is the intermediary who can take advantage of price differentials due to various qualities and not the grower, incentives to invest in quality methods at the farm level are stifled.

In the consuming country, international traders pass the green coffee beans on to roasters at wholesale prices who process the beans further and sell them to retailers. Unless coffee is sold as 'single origin', roasters blend various coffees together, roast the blend and ground it – unless the coffee is sold as whole bean - and repackage it. A separate manufacturing process is required for instant (soluble) coffee production. Trade in instant coffee and in roast and ground coffee takes place almost only between consuming countries.

### **2.1. The nature of coffee prices and their influence on the production cycle**

Apart from their origins or via spot markets, physical coffee supply can, in theory, also be accessed through futures markets. These serve however less as a supply source and more as providing hedging against risk and as the determinants for international green coffee prices. The futures prices are a short-term synthesis of market fundamentals like production, consumption and stocks and of technical factors like hedging and reactions to trigger signals. The prices of the physical trade of Arabica coffees from different origins are set as differentials to the futures prices as they are quoted at the New York Coffee, Sugar and Cocoa Exchange (CSCE) while the reference price for Robusta coffees is set at the London International Financial Futures and Options Exchange (LIFFE). Prices in the physical trade from various origins are set as differentials in relation to these future prices which depend on the reputation of the quality of the origin, and are regularly published by the International Coffee Organization (ICO) in the form of indicator prices (Ponte 2001)

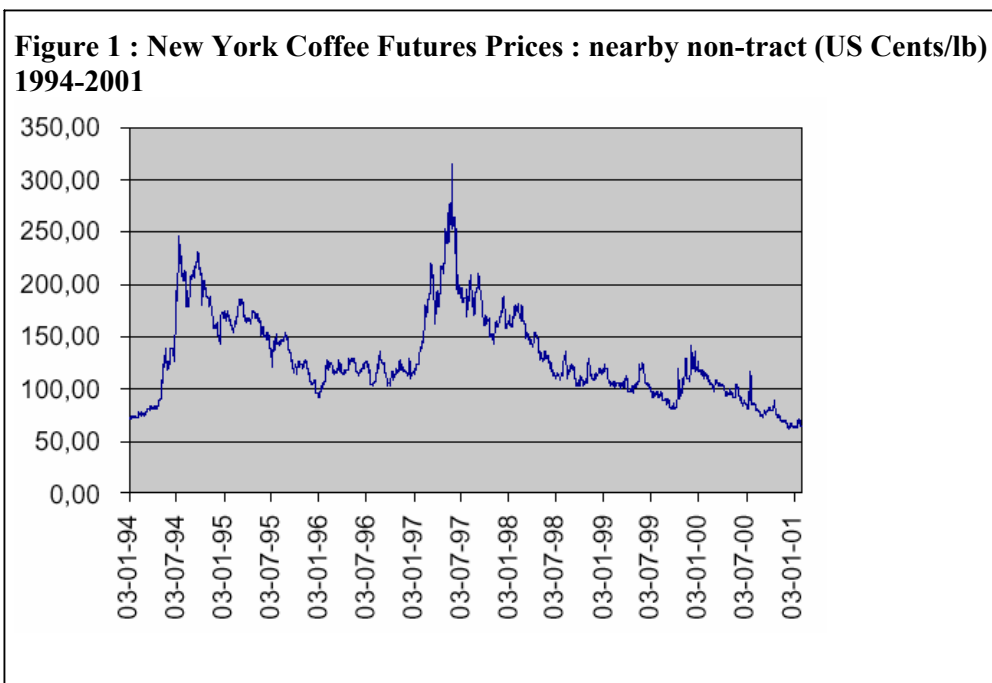
International coffee prices tend to be inherently volatile due to the characteristics of the price

elasticities for both supply and demand. Coffee demand drops significantly only at times of large increases of coffee prices and is particularly insensitive to price drops. World price elasticity of demand is estimated at around  $-0.2$  on average (Akiyama and Varangis 1990 ; Lord 1991). Supply elasticities are low in the short run and higher in the long run because it takes at least two years for new trees to be productive and several others before they reach full production levels. They are estimated at about 0.15 in Latin America and 0.2 for Robusta in other countries than Brazil and Vietnam, with a 3-year lag on prices (Lewin et al 2004). The mean lag of exports behind prices is valued by Lord (1991) at five to seven years. Higher prices follow a production shock which raises production which drives down prices again until they are below their long-run marginal production costs. This pattern leads to price cycles of approximately seven years duration that are characterized by short periods of high and volatile prices followed by long periods of low prices and low volatility. In this context, the value of coffee stocks becomes key for the determination of international coffee prices : Since demand does not react strongly to moderate price changes, consumption must be met from stocks when production drops suddenly, which raises their value to the extent that they risk to be eliminated. The following price rise induces an increase in production which again lowers prices. Due to the low elasticity of demand, the expansion of supply drives down prices below their marginal production costs which will in turn lower supply below demand, raising prices and the value of stocks (Lewin 2004).

Price variations as such do not necessarily constitute an economic problem, as long as they are foreseeable and can be factored into investment decisions of producers. This is however not the case for most commodities for which the variations around an apparent long-term trend is often far in excess of the size of the trend itself. It is then often unclear if a certain price movement constitutes a variation around a trend or rather a real shock. Unpredictability, especially when combined with limited access to market information, makes production



planning for farmers more difficult and leads to ill-informed investment decisions based on price movements that are largely unrelated to demand (Oxfam 2002). When prices hike, more trees are planted that only start producing fruit when coffee prices may be very low again, exacerbating the price slump. They also become fixed assets that make a transition into other commodities more difficult. The memory of cyclical fluctuation can also induce them to wait for better times even when prices are below production costs while short-term volatility obscures long-term price trends and thus limit the ability of farmers to respond to market signals. The sequence of renewed plantings and tree renovations that follow occasional price spikes induced by a production shock due to frosts or droughts in the largest producing country, Brazil, together with increasing productivities and rising production following the entry of new low-cost producers have led to a long-term decline in prices. Since 1970, prices have declined by about 3 % per year on average for Arabica and by 5% for Robusta coffees and are now at their lowest level in 100 years if adjusted for inflation (Lewin et al. 2004).



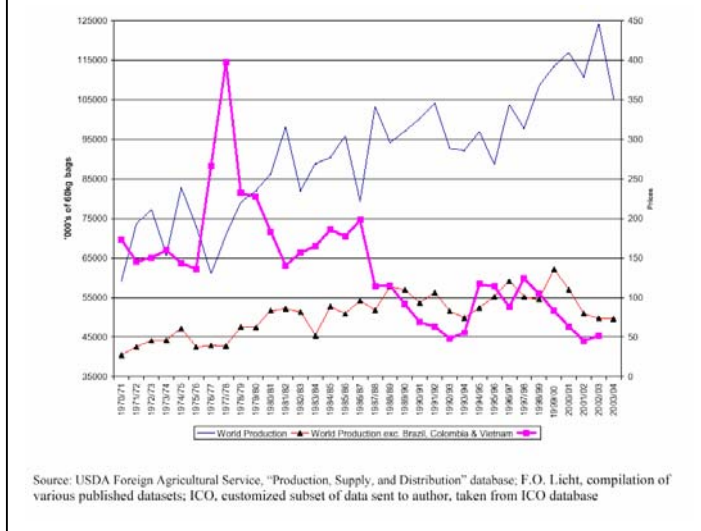
Source : CSCE

## **2.2. New developments in the coffee market**

### **2. 2. 1. Supply**

In spite of this long-term decline in prices, production has steadily grown while demand has not kept up. World production has risen by 1.8% per year on average since 1964/5 while demand has only risen by about 1% per year in the same time period (see figure 2). The excess production has been held in stock in both producer and consuming countries. International traders hold stocks both for speculative and precautionary reasons. During the time of the International Coffee Agreement, stocks have been predominantly held in producing countries as governments and marketing boards in these countries were responsible for exporting the coffee and for sticking to their allocated export quota. With the end of the ICA, consumer stocks have grown as surpluses have built up, while producers are largely unable to finance their retention in the producing countries. In May 2003, stocks in consuming countries were about 21 million bags, corresponding to about 12 weeks of global supply, up from 7.6 million bags (5-weeks supply) in 1996. In December 2000, green coffee stocks in the US reached more than 20% of its annual consumption (Oxfam 2002) and, according to an analysis by the Economist Intelligence Unit from the same year, stocks were expected to rise to 75% of world consumption by 2002. The negative impact on prices is generally considered to be stronger in the case of a build-up of stocks in consumer hands than when they are held in producing countries (Lewin et al. 2004).

**Figure 2 : Production has risen as prices have fallen**



There are several explanations for this increasing trend towards oversupply that have to be combined. Producer responses to sudden big price increases as they have been outlined above are one factor. The end of the ICA and the abolition of marketing boards in producing countries also brought a

higher share of the export price to producers (Krivonos 2004; Akiyama et al. 2003), increasing incentives to produce more. Another reason is a fall in production costs in Brazil which invested heavily into production techniques and induced higher yields and the entry of new low-cost producers, particularly Vietnam, into the market. Inconsistent policy responses that delayed market exit in the case of price falls but encouraged market entry as prices further fuelled over-supply.

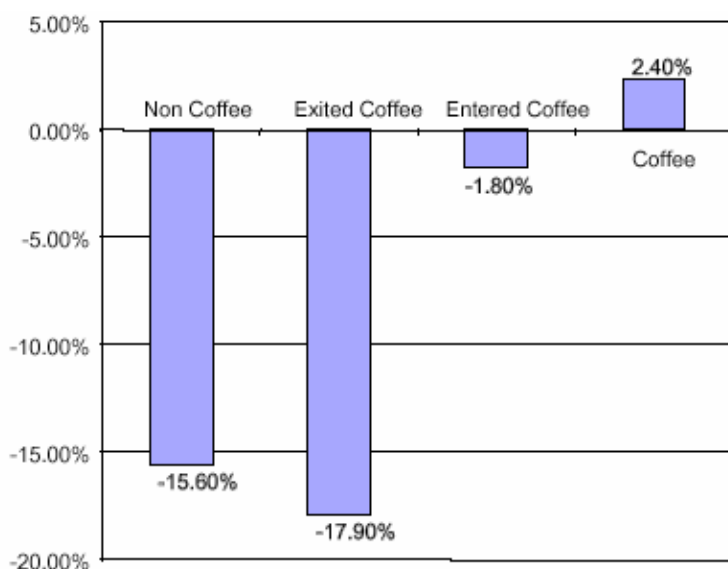
Within this overall trend there have been winners and losers, both between producing countries and within them. Countries best able to manage production costs have generally shown the highest growth rates which has caused global supply to become much more concentrated : USDA data show that while the three biggest producers, Brazil, Colombia and Vietnam together accounted for 44% of the world production in 1992, their share constituted 60% of world supply in 2002. Other countries were unable to expand production after price increases due to high carry-over debts. This fact is socially problematic since many of the small countries that are negatively affected by the actions of larger producer countries also have a substantially larger economic exposure to coffee and depend more strongly on export earnings from coffee sales (Lewin et al. 2004).

The surge in Brazilian production is due both to the liberalization of the coffee sector which removed export and internal taxes as well as credit restrictions and thereby increased the farmers' share of FOB prices to approximately 90% and to widespread replanting in new areas after the 1994 drought. Higher and more consistent quality of Brazilian coffees has had substantial impacts both on Robusta producing countries in Africa and Asia and on Central American countries that produce washed Arabicas which were traditionally regarded as higher quality than Brazilian Naturals coffee producers. Recent increases in the availability of pulped Naturals (semi-washed Arabicas) which are of similar quality as the washed type but cheaper to produce has induced a large swing of the mainstream coffee industry towards these coffee and away from the Central American washed coffees. In combination with a resurgence in high-quality Colombian Milds Central American countries now feel a double squeeze from both high and low quality products. Roasters are relying more and more on the combination of coffee types of the three largest producing countries. Coffee production has actually fallen in Latin American countries over the last three consecutive years (Lewin et al. 2004). The social consequences of the price crisis have also had knock-on effects such as bank failures and public protests.

Within countries, high debt or low capitalization levels reduce the ability of small-scale producers to take advantage of price increases in comparison to larger growers (Porter 2000). In Nicaragua, many workers on coffee farms were able to find alternative employment whereas poverty rates increased by 2% between 1998 and 2001 among small coffee producers that stayed in the sector although it fell by 6% for rural households overall (World Bank 2002). While the end of the ICA has led to a rise in the share of the export price received by the producers, the fall of export prices themselves outweighs this increase. The economic losses for small farmers are estimated at \$4,5 billion per year, and numerous reports give evidence of human hardships among this part of the population (IDB, USAID, World Bank 2002, Oxfam 2002). Colombia's coffee regions, for example, have suffered clear and

measurable setbacks in key social indicators. Particularly smaller farms have had to reduce food consumption and the attendance or the number of school enrollment of children as a result of the coffee crisis. In Nicaragua, poverty rates increased by more than 2 percent between 1998 and 2001 for farmres who stayed in the coffee sector while they fell by 6 percent for all rural households overall. While the net primary school enrolment rose by 10% for all rural households, they fell by more than 5% for those same households (see figure 3)

**Figure 3 : Nicaragua : Changes in Poverty Rate 1998-2001**



Source : Oxfam 2002 ; World Bank 2002 ; ECLAC 2002

Farmers are also the ones that make most of the physical investment and therefore bear most of the risk from the cyclical nature of coffee production and from unpredictable price volatility. At the same time they are also the actors that have least access to instrument to manage and financially hedge risk on the futures markets. The developments since the 1990s were accompanied by a widespread abolition of marketing boards in many producing countries in the context of broader liberalization and structural adjustment programs. While the problematic nature of many of these marketing boards with high levels of inefficiency

and/or corruption, particularly in Africa, has been largely recognized, their abrupt abolition also meant that farmers were left without technical and credit assistance and more importantly without any market information and experience in exporting. The conventional market is marked by asymmetries in the distribution of market information : easily accessible public information is often inconsistent and the best one available is mostly withheld by large traders. Another factor leading to a worsening of the quality of information and data flows to the producers with the end of government involvement in exporting processes was funding shortfalls for statistical bodies in producing countries as a result of low prices (Lewin et al. 2004).

Why is the adjustment of supply to declining prices by diversification out of coffee production so difficult ? A structural problem of the coffee market is that the entry barriers for producers are relatively low whereas "exit barriers" are relatively high due to the nature of coffee as a permanent crop that accumulates some capital in the plantation. These "specialization traps" at the micro level are aggravated by the lack of information and financial support for transformations of production just mentioned (Muradian and Pelupessy 2004).

Furthermore, the long-term decline of prices in most export crops (like cocoa, cotton or corn) produced in developing countries means a lack of production alternatives for most producers since producer prices in these crops tend to be even lower or production costs higher. Agricultural protectionism of the US and the European Union further prohibits profitable diversification into other major food crops and distorts relative prices. We should also bear in mind that diversification out of coffee may not necessarily be socially optimal from a public goods perspective : Small-scale coffee production is regarded one of the least environmentally harmful agricultural activities in terms of conservation of biodiversity and soil fertility as well as a carbon dioxide sequestration. If diversification into other agricultural

activities is undesirable and often unfeasible, the only alternative for farmers is migration to the cities, which often has as a consequence the destruction of the social fabric in rural areas and an increase in economic and social problems such as urban unemployment.

### **3. 2. 2. Structural changes in the coffee value chain**

The end of the ICA regime has profoundly affected the balance of power in the coffee chain, shifting to a dominance of consuming country based operators over agents in producing countries – farmers, local traders and governments. The post-1989 coffee value chain is characterized by a simultaneous process of power concentration in importing countries, and power deconcentration in producing countries. Seventy percent of global coffee is grown by small-scale farmers (less than 5 hectares) who according to Fitter and Kaplinski (2001) in their majority sell atomistically into commodity markets. Ponte (2004) describes the value chain of coffee as a typical example of a "buyer-driven" chain, or more specifically a "roaster-driven" chain where the strategic choices of coffee roasters have shaped both barriers to entry both at the roaster level and in segments further upstream (i.e. closer to production).

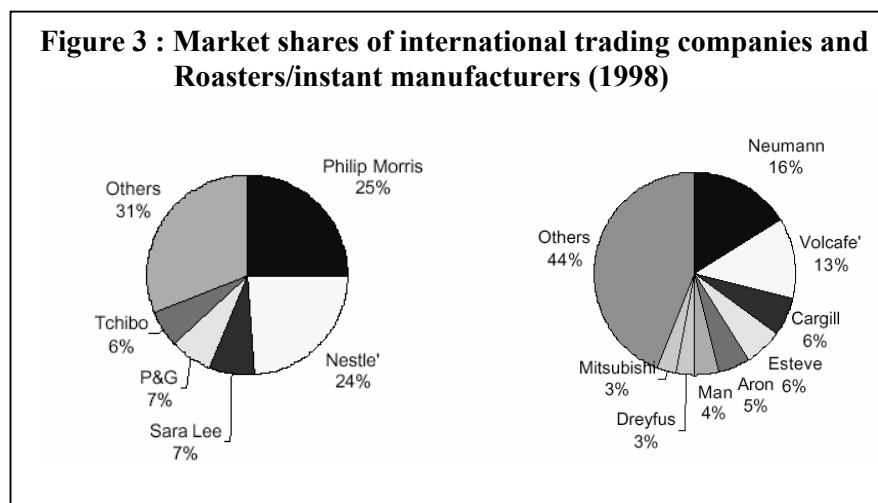
Increasing levels of concentration in the mid-1990s has enabled roasters to work with lower inventories and to push just-in-time logistical supply demands down to their suppliers by adopting so-called "supplier-managed inventory systems" (SMI). The effect on coffee trade of this trend together with the development of stock levels is a need to hold wider ranges of origins of coffee for rapid delivery which increased requirements of logistical and financing capabilities placed on suppliers. This outsourcing of supply and quality risk through forward contracts has favored the largest trading companies and has therefore led to considerable concentration at this part of the supply chain as well. While grower organisations have had difficulties in substituting governments as organizers of coffee exports, many local exporters have not been able to raise the necessary funds to compete with international traders and have

either disappeared or allied themselves with them (Ponte 2001). One reason for this development is the unequal ability between market agents to deal with price volatility which has increased as a result of both the end of supply controls in the ICA and the developments in commodity exchange markets related to speculation and an increased activity of investment funds (Oxfam 2002). While future markets and forward contracting allow hedging market risks for large market agents and increase their flexibility, farmers and local traders in producing countries do not easily have access to these instruments.

As a result, the two largest (Neumann and Volcafé) now hold 29% of total market share ; the top six 50% (Ponte 2001). At the roaster level concentration of market power is even higher: The top two (Nestlé and Philip Morris) hold 49% of market share for roasted and instant coffees and the top five for 69% (Nestlé, Philip Morris, Sara Lee, Procter and Gamble and Tchibo). They also account for 40% of the retail market. Concentration is even found to be higher in some national consumer markets : In the USA, the top five roasters account for 80% of the market, and for 84% in Germany (ITC 2002). The profitability of roasters derives from economies of scale due to their sheer size and the volumes they buy, from brand power established by huge investments into advertising, from cost management their increase in flexibility, both with regards to financing and with blending. The latter refers to the practice of roasters to mix and match various coffee types from different countries into one final coffee product. The ability of roasters to use a larger proportion of cheaper and lower quality Robusta and Brazilian Arabica beans in mass-oriented blends also derives from recent technological developments and innovations in the roasting process. The great variety of tastes and "quality" notions between countries favors scale economies and a transnational organizational structure while it imposes upgrading constraints to agents in producing countries. The ability to create different blends with similar taste characteristics for a relatively stable price has helped the coffee industry deal with large swings in both prices and



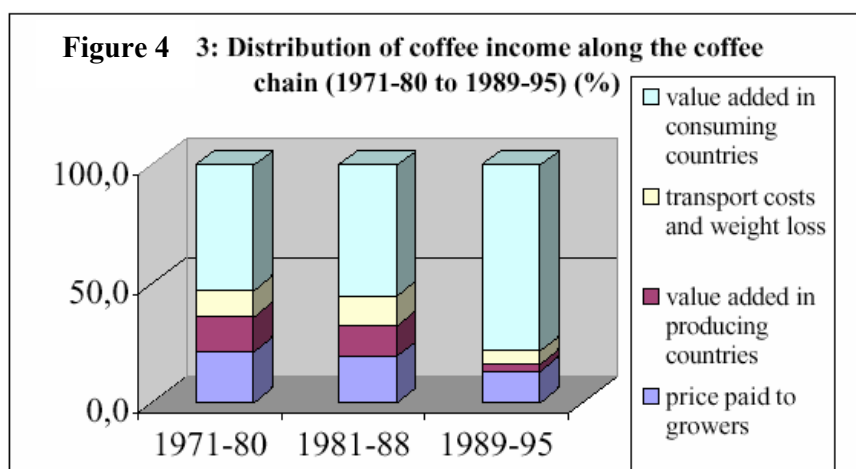
the availability of coffee from different producing countries. According to Ponte (2001), there is little interest in vertical integration upstream under current market conditions for the traditional roasters, and the conventional market is thus likely to remain governed by arms-length relationship and/or forward contracts of short duration (under 12 months) as long as there is over-supply and roasters manage SMI systems effectively.



Source : van Dijk et al. 81998, 34)

Finally, the food retail sector is also highly concentrated in the US, the UK and Northern Europe and plays a dominant role in the food marketing chain. Globally, most coffee for in-home consumption is purchased in supermarkets, 60% in the case of the United States in 2001. Yet, through consolidation and with massive investment in advertising their brands, roasters have kept control of the coffee chain in spite of development of private coffee labels by supermarkets. Retail margins are lower for coffee than for the average food portfolio, and in the US, supermarkets sometimes even sell cheap coffee at a loss to attract consumers and entice them to buy other, higher-margin items. Coffee recently moved into even lower profit margin outlets such as warehouses and discount stores like Walmart.

The combination of producer prices at record lows that have not translated into lower retail prices of coffee and the asymmetric power structure in the supply chain has led many observers to conclude on high company profits due to uncompetitive behavior of the largest multinational corporations and to the perception of a lack of "fairness" in the distribution of the gains from coffee trade. When international coffee prices declined by 18% on world markets between 1975 and 1993, the consumer price in the US increased by 240% even though transportation costs have decreased during that period and trade barriers are low for coffee (Morisset 1997). This has caused the share of the final retail price received by producing countries to decline significantly (see Figure 4). In 1998, less than 30% of the value of world coffee sales remained in producing countries<sup>1</sup>.



Source: Adapted from Talbot (1997a: 65-7)

We should bear in mind that this decline is both a result of profits at the roaster and retail level that are realized by taking advantage of value-adding activities such as branding, marketing, and the development of new products like soluble and flavored coffees, and of the fact that non-coffee costs that are included in the final retail price, particularly rent and labor,

<sup>1</sup> Calculation based upon total value of coffee exports from developing countries and compared with total value of world coffee sales (MTI/ICO. 1998. International Coffee File)

have grown and present a more significant share of the total retail price (Lewin 2004). These value-adding costs are independent of the price of green coffee. However, the hypothesis of the Fair Trade movement that roasters and other agents in consuming countries are making profits that would not be possible in a more competitive business environment finds some support by the results of Shepherd (2004) who examined price transmission through the coffee supply chain from the producers to the world market and from the world market to consumers following liberalization. The finding that improvements in price transmission were quite limited in terms of speed and completeness and that asymmetric transmission at all market levels has become even more widespread is taken as an indication that firm concentration at intermediate levels in the chain may have a significant influence on market prices and quantities. In particular, he finds that price transmission to consumer markets was considerably faster and more complete prior to liberalization and that marketing margins have increased in consumer markets. Top-down price transmission is equally a more important driving force in producer markets but not in consumer markets after liberalization, which lends support to the description of the coffee value chain as “buyer-driven”. These results are important from a distributional perspective: While market imperfections resulting from government interventions in favor of agents in producing countries were also present during the period of the International Coffee Agreement, current market failures favor the most powerful agents of the chain in consuming countries (Muradian and Pelupessy 2004).

### **2. 2. 3. Quality and public goods problems**

In addition to these distributional concerns, the current situation is believed to lead to a generalized quality problem. The disintegration of the ICA, concomitantly with liberal policies by the Bretton Woods institutions, induced producing countries to dismantle national

coffee boards that had formerly embodied coffee quality mechanisms. In the current market situation, where producers are receiving undifferentiated commodity prices that are often below production costs and unrelated to the individual quality they supply and where major roasters source for cheap supplies, farmers lack the economic incentives and capabilities for investing in quality improvement on their own.

While traditional coffee production is generally considered one of the agricultural activities with the least negative environmental impact and can indeed serve to preserve habitats that resemble rain forests, recent production increases in some countries have entailed additional clearing of forested area and/or the transformation from shade-grown to intensive sun-grown production methods (mono-cropping). These methods are environmentally inferior to traditional, more-diverse multi-species and shaded coffee plantations (Muradian and Pelupessy 2004). The commodity trading system of the conventional coffee market where prices are set according to the New York or London exchange does not allow for the internalization of public (environmental) goods such as biodiversity and water and soil retention.

#### **2. 2. 4. Paradigm Shifts in Coffee Demand**

The reason why roasters and retailers have invested heavily in product innovation and segmentation is that the mainstream coffee market is considered "mature" and exhibits low growth levels of overall consumption (about 1% annually between 1987-97). Contrary to low price elasticity, income elasticities are rather high, but consumption tends to level off at the highest income levels. Three trends can be observed in global coffee demand : (i) a severe struggle for market among major established brands in the mature and relatively stagnant market ; (ii) rapid consumption growth in coffee-producing countries and emerging consumer markets in Eastern Europe, Russia and Asia some of which are traditionally tea-drinking

nations. This expansion is largely driven by access to cheaper, lower-quality coffees like soluble products that heavily use Robusta ; and (iii) the emergence of a differentiated coffee segment at the high price end. Lewin et al. (2004) compare the overall market with a pyramid where healthy growth is found at both the bottom and the top end, while the middle segment which still constitutes the highest volume and uses mainly Arabica Milds exhibits most problems. For producers, the low end does not offer many product upgrading possibilities because most value is added through manufacturing processes in consuming countries and because high trade barriers against coffee processed into soluble form in consuming countries exist. We will therefore turn our attention more closely to the high-end market since this is the segment that appears most promising to producing countries.

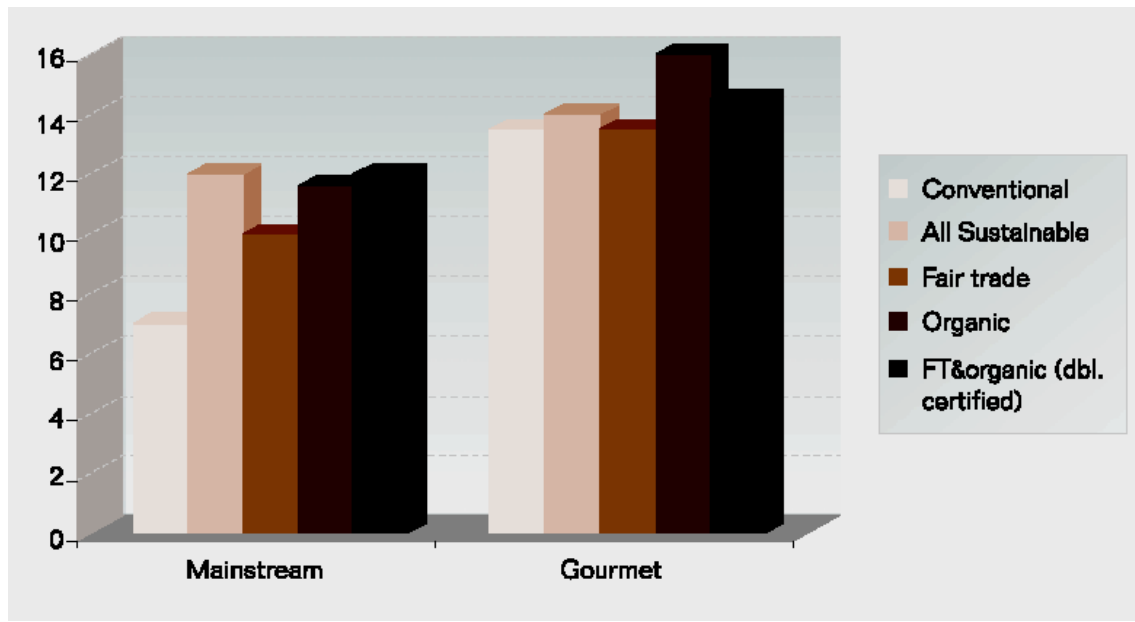
### **2. 2. 5. The Emergence of the Specialty Coffee Market**

While barriers to entry in the traditional coffee marketing chain have increased in both trading and roasting, recent signals suggest a fragmentation of the market with the emergence of new consumption patterns. If a commodity is defined as a factor or product where there are low barriers to entry, which is subject to intense competition and hence declining terms of trade, then product differentiation can be seen as a form of decommodification (Fitter and Kaplinsky 2001).

The term "specialty coffee" nowadays covers basically all coffees that are not traditional industrial blends, either due to high quality and/or limited availability on the production side, or due to flavoring, additional coffee processing to produce decaffeinated or soluble coffees and/or packaging and "consumption experience" on the consumption side (Ponte 2001). For our purposes, an important distinction has to be made between these two categories of differentiation since the first gives agents in producing countries an opportunity to upgrade

their product whereas the second way of adding value takes place exclusively in consuming countries. The same low or medium quality bulk coffees can be used as ingredients for these blends. When using the term product differentiation and "specialty coffee" market, I am therefore referring to the market segment which is made up of gourmet and quality coffees, as well as to "sustainable coffees" which include Fair Trade coffee as well as organic and shade-grown. This segment has experienced significant growth rates over the last few years. Currently, the total volume of differentiated or specialty coffee imports account for 9-12% of the developed consumer markets, and they make up a higher share of the total market value due to their higher prices. The US specialty coffee market offers a striking example, accounting for about 20% of the volume but more than 40% of the total value (Giovannucci and Koekoek 2003). Differentiation is occurring on various dimensions. The gourmet market uses taste characteristics, i.e. excellent quality which is often but not necessarily associated with a particular origin of the coffee, as a marketing tool, sometimes in conjunction with a specific consumption experience generated by a particular atmosphere in out-of-home consumption. Sustainable coffees incorporate credence attributes that refer to certain methods of production (organic, shade-grown) and/or commercialization (Fair Trade) which are identifiable by the consumer due to a label on the package of the product which is generally attained by third-party certification. Figure 5 shows the broad range of shelf prices of various coffee products in the case of the German market.

**Figure 5 : Retail prices of German coffees by type (price in Euros/kg)**



Source : Giovannucci and Koekoek 2003

What are the effects of product differentiation on the structure of the coffee market?

There is some evidence that the specialty coffee market has an impact on the power of roasters within the value chain. Accompanying a growth in café chains, particularly in the United States, there has been an explosive increase in the number of roasters. By 1993, roasters had lost 12 % of the market share to Starbucks, other regional cafés and specialty roasters (Ponte 2001). This number should have largely increased by now, given the strong growth rate of the specialty sector during the last decade which poses a challenge to the practices of traditional roasters who sell large quantities of relatively homogenous and undifferentiated blends of mediocre or poor quality and compete on prices, packaging and flavor. Where brand development in relation to a particular origin or estate requires security of supply, roasters may be pushed towards closer forms of coordination with international traders and exporters (Ponte 2001). The fact that particular taste properties and production methods are critical for these coffees should also give more bargaining power to agents in producing countries (Muradian and Pelupessy). A recent development within the differentiated market is that its products, self-branded or as part of private label programs, are

entering the same mass distribution channels as conventional coffees. They are also making headway through other channels of distribution with lower entry barriers such as out-of-home consumption, gas stations etc. Their success led most owners of dominant mainstream brands who initially shunned these products to participate in this market in one way or another.

Still, it is unclear how product differentiation affects coffee producers. Fitter and Kaplinsky (2001) argue that the returns to differentiation tend to accrue to the nodes closer to consumers.

Their analysis is based on the increase in price variations in final product markets and as traded in global commodity markets which they find not to be reflected in a similar process of price differentiation for farmers. However, their analysis also includes all the differentiation attempts of the major agents in the conventional market by branding and by adding value in the form of further processing as in the case of the instant and soluble coffee market. We should therefore not jump to quick conclusions about the distributional effects of the product differentiation in terms of quality or sustainable labeling that I am referring to.

In any case, adding value to green coffee in the producing country is generally not an easy option since it entails promoting quality improvement, raising the reputation of an origin, and requires good marketing skills and sometimes costly physical investments.



### **3. The Fair Trade response to the coffee crisis**

In the absence of government intervention in the sector, voluntary "sustainable" certification schemes have been designed as market-based policy instruments to achieve simultaneously a variety of social goals, related to health, the environment, social justice and poverty (Muradian and Pelupessy 2003), under the slogan "trade not aid". In this section, the complex mechanism of Fair Trade and the interactions between the various Fair Trade agents – the standard setting and accreditation body, national certification organizations, coffee buyers and producer cooperatives – shall be explained.

The various national Fair Trade initiatives have harmonized their standards and coordinated their activities through an umbrella organization, the Fairtrade Labelling Organizations International (FLO), which is now the authoritative body for the Fair Trade standards giving formal recognition to the national certifying bodies. FLO now represents members in 17 countries. Under the Fair Trade mechanism, organizations or companies buy coffee directly from producer cooperatives that have been registered by an independent certification body. In turn, these coffee importers obtain certification from the same body which allows them to display the Fair Trade label of the certifying body on their product. They have to pay a fee for obtaining certification but displaying the label allows them to charge higher prices from consumers. As of March 2004, FLO International worked with 197 coffee producer partners in Africa, Asia and Latin America of which many export themselves. In addition to the cooperatives, 33 export partners are FLO registered. Altogether, 105 importers, manufacturers, roasters, distributors and 402 licensees in the 17 national member countries operate through the system<sup>2</sup>.

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<sup>2</sup> FLO website. Accessed March 18, 2005.  
[www.fairtrade.net/sites/products/coffee/partnres.html](http://www.fairtrade.net/sites/products/coffee/partnres.html)

Coffee importers using Fair Trade labels must uphold the following standards:

- 1) Purchases must be made directly from grower organizations using purchasing agreements that extend beyond one harvest cycle. Importers are required to give producers an annual non-binding, but good faith estimate of the quantities and qualities it plans to order over the next year
- 2) Importers must pay producer cooperatives a guaranteed minimum price (\$1.21 per pound of Arabica coffee) and pay an additional social premium (\$0.05/lb) which is supposed to be used for community development projects by the producer organizations. This "fair price" minimum was set by consultation with a number of international bodies, including the International Coffee Organization as the price that covers costs of production and a reasonable margin. Coffee which is in addition certified as organic receives a further premium of \$0.15/lb.
- 3) Importers must offer pre-financing equal to 60% of the contract value upon request

**Table 1: Guaranteed minimum prices for Fair Trade coffee as specified by FLO-International (US cents per lb. FOB – Feb 2000)**

<i>Type of coffee</i>	<i>Regular</i>		<i>Certified Organic</i>	
	<i>Central America, Mexico, Africa, Asia</i>	<i>South America, Caribbean Area</i>	<i>Central America, Mexico, Africa, Asia</i>	<i>South America, Caribbean Area</i>
Washed Arabica	126	124	141	139
Nonwashed Arabica	120	120	135	135
Washed Robusta	110	110	125	125
Nonwashed Robusta	106	106	121	121

Source: FLO, International Conditions for the Purchase of Coffee, partly available at [www.consumerscouncil.org](http://www.consumerscouncil.org)

To be included in FLO's approved registry of growers permitted to supply Fair Trade coffee, producers must also uphold a set of standards :

- 1) They must be small family based growers (not structurally dependent on permanent hired labour, managing their farm mainly with their own and their family's labor-force<sup>3</sup>) Large coffee estates, and with them the workers employed by them, are thus excluded from participation.
- 2) They must be organized into politically independent democratic associations
- 3) They must pursue ecological goals conserving natural resources and limiting chemical input use. They should implement an integrated crop management (ICM) system which minimizes the use of fertilizers and pesticides and gradually replaces them with organic fertilizers and biological disease control.

The FLO standards contain both minimum and progress requirements concerning these standards which cannot be examined in detail here due to space constraints. The certification organizations monitor both traders and producer associations to insure that these conditions are upheld. Thereby they guarantee to the consumer that the product that is certified as Fair Trade has come from a small producer who is a member of a cooperative that is following the guidelines of FLO. To remain in the FLO Fair Trade register, cooperatives are required to go through an annual follow-up and monitoring visit where the inspector reviews all of the sales records of the cooperative and the commodity chain from producer to buyer. He also confirms that the price premium and the social premium have been used to assist in the process of social development and are being managed separately.

It is important to note that although Fair Trade includes an environmental requirement which is also monitored by the Fair Trade inspector, the fulfillment of that requirement does not

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<sup>3</sup> FLO Fair Trade standards, available from [www.tradefair.net](http://www.tradefair.net)

automatically entail « organic » certification. While the members of a cooperative that has obtained Fair Trade certification are all expected to gradually move towards organic production techniques, only the ones that obtain external organic certification by a separate organic certifier outside of the FLO system also reap the organic premium of \$0.15/lb above the Fair Trade price.

To evaluate Fair Trade as an instrument for poverty alleviation and development I have chosen one specific community called “La Unión Majomut” located in Chiapas, Mexico, for which a range of data was available as a case study. Mexico produces Arabica coffee and international prices for its coffee are determined at the New York exchange. The price crisis has hit this country hard, in particular its five southern states, which are the main coffee producers : Until recently, coffee has been the most important agricultural source of foreign exchange in Mexico. The coffee harvest generates 500,000 jobs and employs a quarter of the economically active rural population, in the southern coffee-producing states even 52% (Perezgrovas et al. 2001). Based on health, housing and education criteria, 84% of Mexican communities in which coffee is the primary agricultural activity are considered to live in very high or high poverty. In Chiapas, where major producing areas are mountainous and have poor communications infrastructures, 69 out of 76 coffee producing communities are considered poor or very poor (Perezgrovas et al. 2001). In 1992, 92% of coffee producers were peasant, or small-scale producers, owning less than 5 hectares and 69% less than 2 hectares. For this last category, there is no need to employ labor. Producers live usually in a subsistence economy and depend on a diversified agricultural strategy.

In the wake of the dismantling of the ICA, Mexico has also phased out the government program of the Mexican Coffee Institute (INMECAFE) which promoted coffee production and sales, through investigation, technical assistance, financing, industrial processing, and export.

### **3.1. Union Majomut's participation in the Fair Trade market**

To understand the implications of this alternative trade mechanism for the people who it is ultimately designed for, I will briefly describe the characteristics of one particular cooperative of coffee producers to then examine how it is affected by participating in Fair Trade. While studying one particular cooperative allows to illustrate the functioning and the effects of the system on the ground in general, we have to be aware of the fact that the costs and benefits of one community may not be the same for other cooperatives that operate in a different national or regional context and exhibit different organizational capacities and characteristics. There are studies (Mendoza and Bastiaensen 2003 ; IIED 2000) that are quite critical of the operation and delivery of benefits of the Fair Trade system.

The coffee producers' cooperative "La Unión Majomut" has been operating in the international commercialization of green coffee<sup>4</sup> since 1983, collecting, processing and commercializing the coffee of its members who delivered their parchment coffee on a consignment basis without receiving payment on delivery. At the end of the harvest cycle, when all the coffee had been sold, the total revenue from sales was distributed proportionally based on the quantity of coffee delivered.

Production of coffee accounts for 80% of the monetary income for the families of Majomut; however the families also produce basic grains for consumption in a system of diversified production. The average farm size is 4 hectares per family of which 1.2 hectares are dedicated to coffee production. They thus do not have to hire outside labor.

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<sup>4</sup> « Green coffee » designates coffee at the processing stage where it is exported

In 1993, Unión Majomut achieved formal registration under the Max Havelaar label, and the first harvest in the Fair Trade system took place in 1993-1994. The unification of the various Fair Trade seals and registers under the FLO meant for Majomut that since 1996-97 it has been supervised by representatives of TransFair-Germany. Two years after entering the Fair Trade market, La Unión Majomut also started selling organic coffee through the Fair Trade channel.

Being included in the FLO register gives the cooperative the possibility to sell coffee at the FLO minimum price and under FLO conditions to the extent that it finds registered coffee importers who are willing to buy its coffee. While the FLO standards require coffee buyers to give estimates to the cooperative of the quantities and qualities they plan to order over the next year, they do not have to make a commitment to buy any certain amount of coffee as "Fair Trade". The system does thus not provide a guarantee to the cooperative with regards to quantities that will be bought and sold through the Fair Trade channel. Those depend on demand in consuming countries for the Fair Trade labeled product. Unión Majomut sells the share of any particular coffee harvest which cannot be sold to Fair Trade buyers on the conventional coffee market. A lack of clarity within the structure of FLO with respect to decision-making mechanisms has been noted by Majomut, leading to a lack of communication between FLO and the producer organization. The guidelines and procedures for the admission of new producer groups in the system are perceived as insufficient by the cooperative.

While the cooperative has to fulfill the requirements established by FLO to sell coffee under the Fair Trade conditions, it has itself set up requirements for the admission of new members. The admittance decision is made by the delegates' assembly of the cooperative, and coffee cannot be delivered until the next harvest. Membership has grown from 1,053 to 1,500 members between 1996 and 2002. Potential new members have to

- Be organized in a community group ;
- Pay 300 pesos (\$32) per new member for administrative costs ;
- Participate for one year in the transition to organic production and pass the first organic inspection : During the transition time, producers use organic production techniques but cannot yet sell their coffee as organic.
- Be a community group from an indigenous municipality ;
- Be reasonably close to the coffee processing facilities so that the transportation of coffee is feasible and profitable.

Individual producers and groups that live in very remote areas are not be able to become members of Majomut and thus will not be able to sell Fair Trade coffee. While data about exact admission requirements to the cooperative prior to entering the Fair Trade market are missing, the report on Majomut notes that the latter have been adapted "to ensure that potential members have a commitment to community development and are not simply seeking a way to get better prices for their coffee" (Perezgrovas and Cervantes 2002). At least the requirement of employing organic production techniques was obviously not present for cooperative members before, since the cooperative as a whole only started growing and selling organic coffee after having operated in the Fair Trade market for two years.

### **3.2. Costs and benefits from selling Fair Trade coffee**

The benefits for peasant producers to sell coffee through a Fair Trade network can be split up into direct benefits resulting from higher raw product prices that they receive from the cooperative and various indirect benefits such as access to training in organic and high-quality production methods, access to new markets or generally organizational strengthening. Since

the amount of coffee which every individual farmer can sell at more advantageous prices depends on the ability of the cooperative to find Fair Trade coffee buyers, an organizational strengthening and the improvement of marketing skills of the cooperative itself will be reflected in an increase of the individual's monetary benefits at a later stage. La Unión Majomut retains some share of the higher price which it receives at the point of export for investments either into community projects or for making other investments (providing training for organic production techniques, buying equipment that will improve coffee quality etc.) that may ultimately benefit the farmer. We therefore have to examine price benefits both for the cooperative as a whole and take-home prices for individual farmers as well as the financial costs from participating in Fair Trade that accrue to the cooperative and to individual farmers. In a further step, the paper will analyze benefits stemming from a strengthening of the cooperative's ability to deliver other services to its members.

### **3.2.1. Individual benefits from price premia**

The average increase in income for any given member of Unión Majomut due to the cooperative's participation in Fair Trade is difficult to determine because it depends on various factors : 1) the price difference between the international coffee price and the Fair Trade price in any given year ; 2) the share of the total coffee production that is being sold as Fair Trade by the cooperative 3) the share of the export price which is retained by the cooperative to cover its costs and investments ; 4) the increase or decrease in the farmer's production costs due to growing Fair Trade and/or organic coffee 5) whether the farmer is certified as an organic producer and therefore receives the organic price premium over and above the Fair Trade premium or not and 6) if he is certified as organic, what share of his production can be sold as organic.



To be able to make any estimate at all, a price comparison shall be made for one particular harvest year for which we have data (2000-2001). Perezgrovas and Cervantes report that for the 2000-2001 harvest the price for Unión Majomut members has been up to 200% above the regional prices. The total value of the average production for Majomut's coop members that produce organic coffee is reported to have been \$ 1,700 ( Perezgrovas and Cervantes 2002). Had it been sold to a regional intermediary instead of through the coop, it would have had a value of only \$550. However, only 59% of Majomut's production was commercialized as organic coffee in that year, thus not every producer benefitted from the organic premium which is included in the reported figures, and they don't tell us how much of this value has been paid out to producers, and how much has been retained by the cooperative. They do not reveal much of this increase in income has been absorbed by an increase in the cooperative's costs necessary to meet the FLO's requirements or in community investments.

We may therefore get a better idea of individual price differences by looking at the differences of prices farmers received per unit of coffee. When the purchase price of coffee on the New York market was \$0.59/pound of Arabica green coffee, peasant producers operating *outside of a cooperative* obtained \$0.35/lb of parchment coffee while members of Unión Majomut received \$0.625/lb for conventional and \$0.95/lb for organic parchment coffee – an increase of 71-157% (Perezgrovas et al 2001). I calculated this increase to be 78 % - 171%.

When comparing prices, we have to take two additional factors into account : 1) the share of the export price that is not paid out to producers (additional cooperative costs and revenues) and 2) the difference between cooperative members selling under Fair Trade and producers that are organized in a cooperative that sells to the mainstream market. Concerning this second point, when Fair Trade producers in a cooperative are compared with *unorganized* producers selling to the mainstream markets, the benefits deriving from Fair Trade alone will

be inflated for the following reasons : First, due to a reputation of inconsistent or bad quality Mexican coffee is discriminated against on the New York Coffee, Sugar and Cocoa Exchange (CSCE) and sells at a differential to its quoted futures prices. This differential can vary from year to year and was about 10% in 2000-2001 (or \$0.06/lb less than the international coffee price). Mexican coffee therefore sold at even less than \$0.59/lb in the conventional market, while Fair Trade coffee was not affected by this differential due to its fixed price. Second, while Majomut's costs for transporting, processing and marketing the parchment coffee of its members is calculated to be \$0.12/lb, intermediary buyers that unorganized producers sell their raw product to are estimated to take off \$0.3/lb or more of the international price for these services. One of the reasons for this is that these intermediaries are found to often operate in a very uncompetitive way, exploiting an oligopsonistic market position particularly in remote areas where producers do not have access to processing or transportation facilities (Oxfam 2002). There is evidence that competition in the case of Chiapas is imperfect, with intermediaries colluding both on the level of interest rates when acting as moneylenders – charging monthly interest rates between ten and 20% - and on the price levels offered to producers (Milford 2004). By combining the functions of money-lending and coffee purchasing, private intermediaries increase their bargaining power vis-à-vis individual growers. Milford also found anecdotal evidence that export companies are separating the state market between themselves to charge producers uncompetitive prices. Producers who are organized in a cooperative therefore already have a large advantage over unorganized farmers which is unrelated to Fair Trade.

**Table 2 : Coffee prices for unorganized, organized and Fair Trade/FT + organic coffee producers in 2000-2001**

	Individual producer selling to intermediaries	Cooperative in conventional market	Cooperative Fair Trade	Cooperative Fair Trade and organic
Purchase price of	\$0.59	\$0.59	\$1.26	\$1.41

coffee at point of export				
Differential (10%)	\$0.06	\$0.06	-	-
Transformation and handling costs	\$0.30	\$0.12	\$0.12	\$0.12
Price of raw material (parchment coffee) going to producer	\$0.23	\$0.41	\$0.625	\$0.95

Taking the \$0.41/lb accruing to an organized farmer selling in the mainstream market as the point of reference, the income increases calculated above decrease to 52% - 131%.

The other fact that these numbers reveal is that in the case of Fair Trade and organic Fair Trade coffee a relatively large share of the export price is neither accounted for by the price of the coffee going to the producer nor by transformation and handling costs of the cooperative. While some of this gap may be pure extra costs related to meeting the Fair Trade and organic requirements, some of it may take the form of additional investments the cooperative makes on behalf of its members.

Before turning to these extra costs and investments, I'd like to point to two further reasons why these estimates may overstate typical benefits to producers :

First, most cooperatives cannot sell all their members' coffee through Fair Trade channels and have to sell the remainder at regular international prices. Payments to farmers for sales of Fair Trade and non-Fair Trade coffee is then often pooled into a single payment which is equally distributed among all members, while farmers who are also certified as organic producers receive the whole organic premium. Unión Majomut's ability to sell all of its coffee for that harvest in the Fair Trade market is exceptional. In a comparative study on different

cooperatives participating in Fair Trade, it is mentioned that this was possible because Majomut had taken over contracts from the cooperative "La Selva" which had just lost its Fair Trade certification due to difficulties to deliver (Raynolds et. al 2003). During the ten years of participation in the Fair Trade Market, the average of Fair Trade sales for Majomut has been 37.5% (see appendix), and most certified cooperatives report not being able to sell all their coffee on the Fair Trade market due to limitations of demand in consumer countries. The share of Fair Trade coffee for most cooperatives seems to vary between one quarter and one half of total coffee sales. When the producer's receipt of the Fair Trade minimum price is insufficient to offset drastic losses of income because of the low conventional price, the price benefit serves as a partial subsidy, offsetting some of the negative impact of being forced to sell coffee at below cost (Taylor 2000).

Second, benefits to producers that are solely related to selling in the Fair Trade market furthermore decrease when cooperatives would also be able to fetch premium prices otherwise due to high coffee quality. Superior quality does not automatically add a further premium to the Fair Trade price, whereas it can enable producers to obtain a price superior to the international market price on the free market. Giovannucci (2003) points out that many Fair Trade coffees are purchased by specialty coffee roasters who would typically pay more than the international market average price. These coffee buyers may require a certain quality also for their Fair Trade coffee, established by a sample and good references before signing a contract. The description of the process of establishing trade relations in the case of Majomut indicates that this applies to the cooperative's business realities, without clearly revealing whether it sells high quality coffee or not. While high quality can therefore be a condition for entering into a trade relationship both in the Fair trade and in the conventional market, it will only be reflected by higher prices in the conventional market. At the same time however, the price premium derived from Fair Trade can be a catalyst for investments in quality

improvement which requires more intensive care of coffee stocks that are often not possible when producer prices are below production costs and/or investment into rather expensive machinery. A discussion of the contribution of Fair Trade to quality improvement will follow when indirect benefits for the cooperative's members are discussed.

### **3.2.2. Financial costs of participation in the Fair Trade and the organic market for La Union Majomut**

This section will discuss the additional costs to both the cooperative and individual producers from their participation in Fair Trade. Generally speaking, certification is expensive and time consuming. As mentioned in the description of the Fair Trade mechanism, while the FLO system rewards organic certification with an additional price premium, the Fair Trade organizations themselves do not assume the organic certification process. This means that cooperatives who sell organic coffee through the Fair Trade system need to go through at least two certification and monitoring processes.

Until recently, one of the most important differences between coffee certified as Fair Trade only and the one certified as organic has been that the costs of Fair Trade certification had been borne by buyers, not by producers, while the latter have to cover the costs for organic certification themselves. All our data describe the situation as of 2002 and refer to this scenario. However, since December 2003, the costs of FLO certification have been assumed by producer organisations. These additional costs seem substantial: Not only do initial inspection costs amount to 2000 Euros, but also a fee for the renewal of the certification has been introduced. FLO's website provides us with details on the latter :

“FLO Certificates are only valid for a limited time period. This is in general one year (...).

For the renewal of certification FLO-Cert Ltd charges an annual fee. The annual fee is a combination of two elements, the annual basic fee and the annual volume fee. Each

certified producer pays an annual fee of 500.00 Euro per calendar year. In addition to the annual fee, each certified producer pays a yearly fee based on the volume sold under Fairtrade conditions in the previous calendar year. Its height is related to the value of the product. For coffee, this fee is 0.015 Euro/kg

Producers that do not sell to the Fairtrade market pay:

1. In the first two calendar years after initial certification a flat fee of 500.00 €.
2. For every subsequent year in which they do not sell they pay an amount corresponding to the initial certification fee.”<sup>5</sup>

This last condition seems harsh. If a cooperative has not been able to sell its coffee in the Fair Trade market in one year, it still has to pay a fee for being on the FLO register. Not having had the financial benefits of the system, it is likely to suffer from resource constraints already which are being exacerbated by the imposition of the flat fee. Since part of these fees are flat rates applied to a cooperative as a whole, members of smaller cooperatives pay proportionally more than those organized in a large cooperative.

The costs for La Unión Majomut’s resulting from selling organic coffee in addition to Fair Trade are not clearly expressed in the Perezgrovas and Cervantes report on the cooperative. In particular, neither the costs resulting from obtaining organic certification, nor how this process works and who participates in it are accounted for. They only mention that the cooperative pays community promoters who are coop members from each community that produces organic coffee, a salary of 300 pesos, equivalent to 8 days of work, which is taken from the Fair Trade social premium. The salary is a compensation for the days that these promoters spend visiting other producers’ farmers and working in training sessions. On these days promoters have to pay laborers to work on their own farms.

To establish the costs for organic certification that Majomut has to bear, we have to rely on estimates from various sources that take all aspects of the costs for organic production and certification into account. Because of its combination of environmental and health claims,

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<sup>5</sup> [www.fairtrade.net](http://www.fairtrade.net)

organic certification requires an audit trail that stretches from farmstead to retail store bin and encompasses every way station en route. In addition to the certification costs (hosting inspectors, maintaining documents etc.), we must consider production costs (household tasks required to meet organic standards) and organization costs (those necessary to maintain organic organizations) (Mutersbaugh 2002).

Perezgrovas et al., in their Mexico study, report a unit cost for certification of \$0.03-\$0.05/lb. This number refers to the contracting of a large-scale group inspection (over 1,500 132-pound bags). Mutersbaugh estimates the costs for annual organic certification inspections at \$450 - \$800. Since the European organic standards are not recognized as equivalent in the U.S. and vice versa, cooperatives that want to sell organic coffee in both markets have to go through separate certification processes and have therefore double the cost. La Unión Majomut sells its organic production only in the European market since it is certified by European certification bodies only. When proposing changes to the current system, the report mentions that inspection costs could be lowered by "doing all *three* inspections in one visit". It is not entirely clear to what inspections, other than the one for FLO, this statement refers to. On its website, Majomut features links with Naturland, a German organic certifier, to IMO-Control (German and Swiss) and to Certimex, a Mexican organic certifier, without giving any indication on the division of labor between the three. In principle, there may also only be one organic inspector and a second one for certifying "shade-grown" coffee. Shade-grown coffee is yet another type of "sustainable" coffee which rewards farm management supporting biodiversity, both flora and fauna, by growing coffee in the traditional way under a canopy of larger trees. Achieving "shade-grown" certification can add up to 20% to monetary income from coffee sales according to a study done in 1996 that is quoted by Perezgrovas and Cervantes (2002). While the report mentions that the producers taking part in the organic program have also been working to improve diversity, it doesn't indicate whether shade-grown certification has taken place that would financially reward these efforts. That

certification costs are seen as rather daunting by the cooperative is reflected in its efforts to promote the idea of unifying the certification processes for Fair Trade, organic and shade-grown coffee under a single "sustainable coffee" label that would include all three criteria. Getting certification from a national certification body with international affiliation and recognition like "Certimex" also greatly reduces certification costs as to using transnational certification bodies. Certimex has been able to certify farmers as a group for slightly more than \$50 each. This is regarded as uncharacteristically low and requires the group to have its own internal control system (Giovannucci and Koekoek 2003). As certification costs decrease in such a scheme, we should therefore expect organization costs to increase since setting up such an internal control system requires time and resources. We do not have the quantitative data to determine the exact effects, but it can be assumed that the costs for an internal control system will be lower than those for external control due to low opportunity and labor costs in the region and a more efficient allocation of resources due to better information. For cooperatives in Oaxaca, Mutersbaugh (2002) estimates organization costs, for example for meeting attendance and other organization infrastructure costs, to amount to \$600 per year or 15% of the sale price.

Once these certification costs have been taken on by a cooperative, there is a potential to sell organic coffee also outside of the Fair Trade system under an organic label only, at a premium of generally 15-20% over the international market price, depending on the arrangement with the buyer. Although Majomut seems to sell all its organic coffee through the Fair Trade channel (at least in the harvest year 2000-2001), the organic market could be a potentially attractive additional market for coffee that cannot be sold under Fair Trade due to demand restrictions. Outside of the Fair Trade system, organic premia range from a low of \$0.10 to \$0.15 over the world market price to \$0.40 to \$0.60 for higher quality coffee. Competitive pressures on premia have in recent years induced quality improvements of organic coffees



that are reflected by the fact that the winners of international and national competitions were repeatedly organic producers, although the certification scheme contains no such requirements (Lewin et al. 2004).

Certification and organization costs affect the net income of the cooperative as a whole and account for a part of the gap between the export price the cooperative receives and the price that is paid out to individual producers. However, we have not yet taken into account the effect of Fair Trade and/or organic certification requirements on the production costs for individual farmers. Meeting the Fair Trade requirements may not impose much additional costs on the individual farmer since their emphasis is more on trade relationships between the cooperative and the coffee buyer than on production methods. The environmental requirements that concern production are rather weak, and if they have an effect on the producer's costs at all, they are more likely to result in a reduction since Integrated Crop Management (ICM) requires less inputs such as fertilizers and herbicides that normally have to be purchased from outside while also raising yields. Furthermore, diversifying the crops grown on the coffee plot by mixing coffee production with other food producing plants may actually increase farmers' income. Perezgrovas et al. (2002) calculate the production costs for middle-and large-scale producers in Veracruz and contrast it to the ones for small-scale organic producers in Chiapas and find the latter to be only half of the former (see appendix).

Certified organic agriculture goes beyond the Fair Trade requirement to adopt ICM and limit the use of synthetic agrochemicals. Apart from using only organic inputs, farmers have to adopt measures of composting, rotation or intercropping of diverse plants, the use of plant cover and terracing to minimize runoff and erosion and to refrain from mono-cropping and clear-cutting of large tracts of land. It is therefore more labor intensive than conventional production. According to a study from 1995 mentioned by Perezgrovas and Cervantes in their

report on Majomut, almost twice the work-days are needed for organic production. Perezgrovas and Cervantes calculate that 1,894 hectares have been managed within the organic program, which represents approximately 180,000 additional work-days each year. This finding is confirmed in Milford's (2004) study of the cooperative ISMAM where organic cultivation is estimated to require almost 40% more work. While this could be seen as eroding the financial benefits for individual producers if they had to hire extra labor, Perezgrovas and Cervantes (2002) regard it as a beneficial side-effect creating increased employment opportunities for community members, reducing their tendency to emigrate temporarily or permanently to search for work. We should bear in mind, however, that in the case of small-scale producers with farm sizes of less than 2 hectares, no outside labor is generally required. If even the increased labor intensity of organic production does not yet create the need to hire outside labor, the additional work will be carried out by the same family members as before, resulting in less leisure and decreased welfare, even if opportunity costs in rural Chiapas are low. It also means less time for growing other crops such as maize, beans and other vegetables. In this case, a decrease in the pressure to abandon their land will only be achieved due to the increase in the household's total income which makes a livelihood by coffee production sustainable.

If the additional labor demand indeed induces a household that has not hired labor before to start doing so, there will be a positive employment effect on the whole community or region while the benefits for the employing household would go down to the extent that their production costs have increased. Whether the overall welfare benefit for that household from growing organic is negative or positive then depends on whether the organic price premium exceeds the sum of salary payments.

A last aspect of organic production techniques is that they can be a viable alternative strategy to the high-input/high-yield strategy pursued by large and medium farmers to increase the profitability of the plantations of small-scale producers that lack the cash resources for

chemical inputs to increase yields. Three quarters of Mexican producers do not invest in pest control and 71% do not fertilize (Instituto Maya, Gran Vision, 1999, quoted in Perezgrovas et al. (2001), probably mainly due to budget constraints. Whereas the passive restraint from using chemical inputs, called rustic production, leads to low yield levels, organic methods that incorporate local inputs and actively manage the production cycle require modest external investments but improve yields and income. Both the quantity and the price organic producers receive for their coffee go up in comparison to the rustic method. Schematically speaking, knowledge and labor costs are replacing capital costs. This should be beneficial from the perspective of poverty alleviation in a region like Chiapas which is characterized by a demographic explosion and unemployment or under-employment and where capital (inputs) is the scarce and labor is the abundant factor of production.

### **3.2.3. Non-price benefits to individual producers**

We now turn to benefits individual producers experience directly from participating in the Fair Trade network beyond an increase in the price they receive from Majomut.

#### **3.2.3.1. Price stability**

Related to the price premium, the benefit from price stability induced by the price *guarantee* has repeatedly been emphasized as being about just as important as the actual price increase, given the extremely high volatility of international coffee prices. It allows them to have confidence in the income they will receive in any given year and to plan the activities and expenses for that year. The price stabilizing effect of the price guarantee is reduced when a cooperative is able to sell only a small fraction of its harvest through the Fair Trade channel. But even in that case, planning will still be facilitated by the provision of market information and the good-faith estimate of quantities to be purchased by the Fair Trade buyers.

### **3.2.3.2. Access to credit**

Lack of credit or warehousing facilities often forces farmers to sell their harvest in advance to cover immediate expenses, without the possibility to choose the timing of their sale. Mendoza and Bastiaensen (2003) point out that the price for coffee sold in advance is about half of the price at harvest. The Fair Trade requirement on buyers to provide producers with 60% of pre-financing at world market rates expands access to credit to cover pre-harvest expenses and other costs. Credit financing by importers in the Fair Trade market has been provided since the 1995-96 harvest and accounted for 30% of the credit financing handled by Majomut during the last two reported harvest years. These loans have had interest rates between 8.5% and 11%. In contrast, before participating in Fair Trade, Majomut had to take up loans from the Banco de Credito Rural (Rural Credit Bank) interest rates above 30% annually. It is also noteworthy that Majomut reports having used loans from the Oaxacan State Coffee Growers Credit Union (UCEPCO) from 1998 to 2000 which offered interest rates within the range of commercial rates for Mexico at that time (12-13%) but having stopped using them due to the availability of better options. Majomut divides up the pre-financing proportionally between the quantities of organic and non-organic coffee that will be collected each year, independent of whether the coffee will be sold in the Fair Trade market or not.

Another factor that can provide greater access to cheap credit observed in other studies is an improvement of the cooperative's image. Fair Trade certification lends producer organizations "a certain prestige since it is assumed that the organization is subject to external monitoring and also demonstrates initiative and a capacity to enter new market niches" (Aranda and Morrales, 2002). In the case of Majomut, there are some indications for such a development : Beginning in the 2000-01 harvest, credit has been given by the Action Fund of Banamex, a

Mexican bank, and the Inter-American Development Bank at interest rates of around 10% annually.

We should again point to the importance of access to credit to finance the pre-harvest production process for individual producers, and to the disadvantage of not being organized in a cooperative at all. In many studies, producers report having to commit themselves to local intermediaries, called *coyotes* in the local jargon, in exchange for up-front credit – at usurious rates. They also fall prey to fraudulent practices such as the rigging of scales or the application of penalties.

### **3.2.3.3. Access to training in organic production techniques and quality improvement**

As explained above, organic production methods that satisfy strict international certification standards require a whole set of skills and the knowledge about these requirements that would not be available to individual producers in isolation. To help producers move into this more profitable market segment, Majomut runs a permanent training program in organic techniques accessible to all of its members that is paid for with the \$.05/lb social premium from Fair Trade. A peasant training center providing lodging, food, technical training and advising for the 50 peasant promoters of the organic production program and the 40 female promoters in the organic vegetable and chicken programs (see below) has been constructed. Each year, producers receive a minimum of six training courses where they also share experiences and the latest technical advances. In addition, training and technical assistance for quality control, the wet washing process and post-harvest storage which each family does separately is provided.

#### **3.2.3.4. Psychological benefits**

An increase in self-esteem and a feeling of control over their lives is noted among the members of Majomut, manifested in an increased interest in continuing their lives as coffee farmers. While the concept of Fair Trade is not necessarily clear to the individual producers that are not involved in organizational activities, they express pride about belonging to a cooperative capable continually improving its infrastructure and provision of assistance in spite of the current price problems.

### **3.3. Collective benefits for the whole cooperative**

While the Fair Trade requirements impose on Unión Majomut to set aside the \$0.05/lb social premium for development projects, the range of investments that the cooperative makes in the name of its members is much wider and aims at quality improvements and the promotion of Fair Trade coffee more generally. A part of the social premium is therefore also spent on things like training in organic production. At the same time, given the large gap between the prices paid out to producers and the cooperative's income, the share of the Fair Trade price going to community development in a broader sense may well exceed the \$0.05/lb premium. From some of these improvements individual members benefit directly as in the case of development and infrastructure projects and training. Indirectly, they benefit from an increased capacity of the cooperative to enter into more advantageous contracts with coffee buyers due to quality improvements and/or better marketing skills that increase the quantity of coffee sold through the Fair Trade channel.

#### **3.3.1. Community development projects :**

Majomut's involvement with community development is not new to its participation in Fair Trade. In the past, it has supported housing projects (with a fund started by Habitat for Humanity), the establishment of community stores, the installation of corn mills and tortilla making machines to ease the work of women, and loans for the purchase of pack animals. Upon the insistence of the FLO inspectors, the focus of its activities, however, has shifted in the last few years (since 1996) towards food security projects through women's groups and on the formulation of public policy with respect to coffee production. The former consists of a program including 400 women who are working in community organic vegetable and chicken production for consumption and the sale of surplus. The latter has involved a number of peasant organizations and has "focused on social development and the recognition of the importance of the participation of peasants in the design and execution of development policy in the rural areas of Mexico" (Perezgrovas and Cervantes, 2002). We have no information on results produced by these initiatives, however.

A peasant micro-bank has also been formed with 114 members, and more coop members are in the process of training that will allow them to join the bank. It permits the families to save some of the money earned from the coffee harvest and make it available for use in future times of scarcity. Majomut also supports efforts in organic corn production and the production of basic grains based on the idea of polyculture and biodiversity which provides additional sources of food for consumption, firewood, lumber and medicinal plants. While the nature of the cooperative's involvement in community development may have changed, it is unclear whether the total amount of money put into these activities has increased on the whole.

### **3.3.2. Investments into quality improvement and organic production**

Maybe more important than these development programs are investments into the processing infrastructure and training since these investments allow producers to move into the differentiated segments of the coffee market that reward for organic production and/or higher quality. The organic training program and training in quality-improving methods at the farm level mentioned before are one part of this effort and are financed with the Fair Trade social premium. Individual farmers take on the first stage of agro-industrial processing after the harvest, wet-processing of the beans, using a hand-driven de-pulper and drying them on concrete patios. How this first stage is carried out has large implications on the quality of the final product. To allow producer groups to capture more of the value added in the coffee production process and to move into the high-quality segment of the coffee market, further investments are necessary, however. The next stage of coffee production, dry-processing, requires more expensive machinery and larger agro-industrial units which have large start-up costs. After dry-processing, the beans are classified and sorted by machine for sale (Porter 2000). Thanks to its participation in Fair Trade, Majomut has been able to take control of this part of the production chain : Over the last three harvest cycles, it has been able to purchase and install an electronic coffee grader (\$90,000) and has constructed an organic coffee warehouse with the capacity to store 5,000 quintals of coffee (\$60,000). Controlling dry-processing and electronic grading is crucial to the ability to guarantee a certain quality to buyers. It is noteworthy that these investments have been substantially co-funded by international aid agencies<sup>6</sup>. This might be a sign that participation in the Fair Trade network facilitates access to other resources like development projects as well. While we have no specific information about this, it might also be possible that these foundations assume some of the cooperative's certification costs. The social premium permits the cooperative to

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<sup>6</sup> On its website, Majomut mentions partnerships with the national and international foundations and development agencies such as the Rockefeller Foundation, the Ford Foundation, the MacArthur Foundation, Habitat por la Humanidad, Oxfam Holland and Novib.



maintain its own technical team, making it independent of outside technical assistance or/and of the presence of government funds for its day-to-day functioning.

### **3.4. Organizational Benefits**

#### **3.4.1. Strengthening of the viability of cooperatives**

In the case of Chiapas, Milford (2004) finds that without the subsidy from alternative outlets such as Fair Trade or organic, cooperatives in the region would not be able to compete with private intermediaries. Cooperatives are disadvantaged compared to private export companies, especially the large multinational ones due to liquidity constraints. However, the existence of these cooperatives, as we have seen before, has a positive impact on local competition and hence a positive effect on the overall price level of coffee that producers can attain in the region which is reflected in a higher price level in regions where there are cooperatives than in those where there are none. While cooperatives in other places in Latin America and Africa export coffee without the support of alternative trading systems, this may be difficult in Mexico where production costs are relatively high because the peso is relatively strong compared to other currencies and because the mark-ups of coffee exporting companies are lower than in many other places. Milford also comes to the conclusion that Fair Trade is more successful at strengthening cooperatives than are government or NGO initiatives. This is attributed to the fact that the ability to sell through the system remains tied to the general economic performance of the cooperative which determines the quantity of Fair Trade coffee that can be sold, reducing the risk of becoming dependent on external support. In addition, the system ensures more effective sanctioning of non-performance since cooperatives are unable to communicate directly with a faceless mass of consumers to persuade them to continue their support. This is different from a relationship with a donor organization that can be negotiated

with directly. A cooperative that does not deliver repeatedly will simply be excluded from the system.

#### **3.4.2. Access to information**

The FLO requirement of long-term relationships with coffee buyers has the effect of subsidizing a period of "apprenticeship" to producer organizations during which they learn about coffee marketing, permits, bureaucratic procedures, export/import transactions, and multiple certifications. Such information is often withheld by middlemen. It contributes to the cooperative's stable operation and a climate of trust and confidence for this learning phase.

Producer-fair trader relationships go beyond just selling and buying. This can be seen in the case of the trade relationship between Majomut and Twin Trading, a British alternative trade organization : Twin provides Majomut with a bi-weekly Bulletin of coffee market information from London and with constant training in the commercialization process. A representative of Twin visits the cooperative once a month to analyze the situation, identify problems and consult. FLO provides Majomut once a year with an updated list of importers which is distributed among the producing organizations inscribed in the Fair Trade register by FLO to help Majomut expand its portfolio of clients. Another important element is the constant feedback that the Fair Trade coffee importers give to their suppliers about the quality of each lot of coffee received.

#### **3.4.3. Organizational capacity**

This learning phase is resulting in a strengthening of the cooperative's organizational capacity which is reflected in various initiatives to extend the scope of Fair Trade in conjunction with other Fair Trade cooperatives. Majomut participates in various forums and campaigns to promote the concept, including in Germany and the US. It is part of the Civil Council for

Sustainable Coffee in Mexico which tries to encourage the industry at the national level to operate using guidelines similar to the ones of the FLO. Together with other producer cooperatives (UCIRI, CEPCO and others), Majomut is promoting a new Fair Trade coffee market within Mexico and has created a new entity, "Agromercados", to coordinate the commercialization of a range of Fair Trade commodities. These opportunities were regarded out of reach prior to the Fair Trade certification process (Murray et al. 2003). Along with other Mexican organizations Majomut is also promoting the idea of unifying the certification processes for organic, Fair Trade and shade-grown coffee to create a single "sustainable coffee" label.

Fair Trade has also created capacities to negotiate with new clients. To promote Fair Trade Majomut sends samples of its coffee to potential new buyers. However, unlike CEPCO who has established trade relations with the US firm Royal Coffee which were first negotiated under Fair Trade like conditions and UCIRI who is pursuing direct relations with Starbucks, Sara Lee, Philip Morris, the Neumann group and the French supermarket chain Carrefour, Majomut does not seem to have entered into direct trading relationship with transnational corporations operating in the mainstream coffee market. Such a development and its outcomes, i.e. the prices that the cooperative would be able to negotiate, would be very instructive in terms of the degree of bargaining power a producer organization can achieve from participation in Fair Trade networks.

### **3.5. Environmental benefits**

The soil conservation techniques used in the 2000 hectares managed within the organic program result in a reduction of soil losses due to erosion of nearly 3,800 tons per year and improve the processes by which rain-water is absorbed. Shade trees equally improve the protection of watersheds and help preserve the soil structure which can strongly reduce the

impacts of excessive rain and droughts. Organic soils further support microbial life which naturally controls pests and pathogens. This helps conserve the springs that the communities rely on for their water supplies. Farms managed for biodiversity can contain up to 64 different species in three levels of vegetation. Apart from the positive effect on on-farm diversification mentioned earlier that can be part of a total yield strategy which helps to manage risk, species diversity improves nutrient recycling, reduces the incidence of weeds and provides bigger carbon sinks.

#### **4. Fair Trade's interactions with the coffee industry at large**

While the case study on Majomut provides insights into absolute benefits that accrue to its participating small-scale producers, it provides only selective answers to one aspect of a larger set of questions we set out to answer. The Fair Trade movement started from the assumption that due to large profits at the nodes of the chain in consuming countries, retail prices could be entirely or nearly maintained at their previous levels while producers would gain a larger share of the final price. Second, the Fair Trade movement ultimately aims at raising world coffee prices to help all producers, not only those involved with the Fair Trade system. Finally, the movement seeks to transform the nature of business relations within the global trading system to the advantage of producers in developing countries. This section will examine the impact of the Fair Trade system on these dimensions.

##### **4.1. Impact of Fair Trade on redistributing benefits between actors in the supply chain**

To make a statement on the effects of Fair Trade on the redistribution of profits we have to consider its impact on other actors in the supply chain. Is Fair Trade an example for the effectiveness of the redistribution of profits in favor of the producers? To answer this question we need to take a closer look at the entire coffee value chain. As a first indicator of the distribution of gains we can use Giovannucci's (2001) finding that in the North American market, sustainable coffees produce positive returns to all nodes along the chain (see table 3)

**Table 3: Average premia paid for organic, fair trade and shade-grown coffees in North America in 2000(\$/kg)**

	Organic	Fair Trade	Shade grown
Importers	0.79	1.63	0.77
Distributors	1.03	1.06	0.97
Wholesalers	1.10	1.28	1.08
Roasters	1.01	1.12	0.90
Retailers	1.41	1.43	1.32
Industry average	1.30	1.36	1.17
Average across categories	1.07	1.30	1.01

Source: Giovannucci (2001)

The average premium of \$1.36/kg (or \$0.68/lb) for Fair Trade coffee that is paid by the various US operators to their respective suppliers is of a similar magnitude as the Fair Trade premium that producers receive from importers when international coffee prices are at approximately \$0.60/lb. With regards to the distribution of income between the nodes occurring in developing and industrialized countries Mendoza and Bastiaensen (2003) also claim that there is not a significant difference between the two value chains. Their findings are based on a comparison between the commercial chain Nestlé-Sainsbury (UK supermarket) for Nicaraguan coffee and the Fair Trade chain from the Nicaraguan cooperative Prodecoop-Oxfam during two years. Depending on the international coffee price level the producer share of the final retail price can even be higher in the commercial chain (18% as to 14% in 1996) but was the same on average over the two years. The comparison of the two chains gives evidence of a competitive disadvantage of the Fair Trade chain, showing both higher prices for marketing licenses, advertising, roasting/storage/transport as well as higher wholesale and retail margins. The interpretation of these results is not straightforward, however. Higher prices can reflect both higher costs as well as higher profit margins at various nodes. The

limited volumes handled in the Fair Trade chain are likely to entail inefficiencies in comparison with the commercial chain due to economies of scale. The authors also point out that expenses for advertising as well as the retail margins had to be raised to convince supermarkets to include the Fair Trade product. The strong role of supermarkets is also confirmed by some numbers reported by the Wall Street Journal which may indicate that Fair Trade roasters incur much smaller profits than their counterparts at the retail level : While the US wholesale roaster "Dean's Beans" had profits of US\$ 0.20/lb of coffee after expenses, the store profits amounted to \$3.49/lb, however before expenses. Transfair USA believes these expenses to be 10-15% more than for comparable goods in the US. Since we lack the data on exact supermarket expenses, it would be premature to make a definite judgment on the nature of the Fair Trade mark-ups. Britain's biggest supermarket chain Tesco claims that the company's profit margin on the Fair Trade product is significantly less than the regular one because of associated costs<sup>7</sup>. Fair Trade coffee may therefore have various effects: First, it may shift some roaster profits to retailer profits or even reduce profits for both. Second, it may increase both costs and margins of all operators in producing countries in equal proportions, having no effect on pure profits of some agents in consuming countries. A third possibility is that pure profits are actually increased for some actors. Some positive effect on capturing more value added by producers can be noted: Taking the numerical example from the Wall Street Journal as a basis, 17% of the final price accrued to the coffee farmer cooperative. This is significantly higher than the 12% of the supermarket price which on average globally go to the grower, according to estimates by the International Coffee Organization and is consistent with Giovannucci's (2001) numbers where price premia that importers pay exceed the average premia across the industry (see table 3). There are, however, other cases where companies obviously had much leeway in manipulating retail prices and we could just as easily conclude that company profits in industrialized countries go up much

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<sup>7</sup> Wall Street Journal. What Price Virtue ? N.Y. Jun 8, 2004, pg. A.1

more than producer costs: occasionally, Fair Trade prices were brought down from retail prices as much as 46% more than comparable conventional products to similar price levels after negative publicity (Wall Street Journal 2004). The final outcome is likely to vary according to the specific national market structure in consuming countries. For example, in Switzerland, one of the countries where Fair Trade has reached its highest market share, retail prices of Fair Trade coffee are only about 10% higher than their conventional counterparts.

To better understand what parts of final prices for Fair Trade coffee reflect pure profits versus increased costs and under what circumstances further research is needed. Such information would be particularly valuable for formulating a growth strategy for Fair Trade coffee that would permit to increase its scope and maximize the benefits accruing to producers at the same time.

#### **4.2. Fair Trade's Ability to Raise Prices Overall**

In the case study of Majomut we have seen that Fair Trade raises prices for its participating producer groups and creates new opportunities for them that are significant. However, the capacity of Fair Trade organizations to provide price stabilization and price premia above market rates is limited so far, generating rents only for selected producers without significantly boosting prices overall (IIED 2000). There is a possibility for communities benefiting from certification to become a sort of "island of wealth in a sea of poverty" (Thomson, 1999). The main reason for this short-coming of the Fair Trade movement is its lack of a mechanism to tackle over-supply, although one could argue that the improved access to market information for producers may help counter mal-informed investment decisions that are contributing to over-supply. From a market efficiency perspective one could even reproach the movement for giving producers misleading market signals by fixing prices at an



above-market level and thereby induce them to stay in coffee production instead of diversifying into other activities. This risk is however mitigated by the fact that Fair Trade producers also obtain more accurate market information and also obtain negative signals about the Fair Trade market to the extent that they will not be able to sell their total harvest through that channel. At the same time, the inability of the certification organizations to certify the total production of its registered producer associations reflects that over-supply is also present within the Fair Trade system. This is due first to the high price premia that make the Fair Trade system (and therefore coffee production) very attractive for producers. Second, until December 2003, barriers to entry have been relatively low because the certification costs were borne by the coffee importers. The total production capacity of the 600,000 Fair Trade certified producers in 26 countries is approximately 100,000 metric tons while the size of exports that were officially certified as Fair Trade amounted only to about 17,000 tons in 2001 (Lewin et al. 2004). Oversupply of Fair Trade coffee and the ensuing necessity of Fair Trade producers to sell the rest of their harvest through other channels reduces the system's ability to have a direct positive effect on overall prices. There are justified doubts that overall coffee prices will ever be able to increase above long-run equilibrium marginal costs under the current system since any such increase in world prices will prompt higher production. Long-run prices would therefore only rise if demand was so high that it would always exceed supply by low-cost producers, an event that is very unlikely to happen at the moment. The only way to defy this logic seems to be through international governmental regulation in the form of commodity agreements.

#### **4.3. The effect of Fair Trade on trading practices in the conventional market**

The third element of Fair Trade's vision is to lead the coffee industry as a whole towards fair and sustainable trading relationships. FLO presents this vision as establishing Fair Trade as "the norm for poor and disadvantaged producers and workers, and a reference for all trade across the world". The question to examine in this context is therefore whether there have been "sustainability standards spillovers" into the conventional market, and how such private initiatives compare to the Fair Trade standards in terms of social benefits to producers and on the sustainability dimension. As to the first question, it is easy to see that Fair Trade as practiced within the FLO system is not the only way in which sustainable coffee production is tried to be achieved and/or market niches to be conquered. According to Gereffi et al. (2001) and Muradian and Pelupessy (2004), four general categories of voluntary certification schemes can be identified, depending on who establishes guidelines and conducts monitoring:

- 1) Under first-party governance schemes, individual companies set standards for their operations and monitor their own compliance. An example for this are Starbucks' "conservation principles for coffee production".
- 2) Codes of conduct such as the "Sustainable Agriculture Information" (SAI) platform can be set by industry or company associations and include reporting mechanisms.
- 3) The FLO system goes further by using third-party certification involving an external group that designs standards and compliance methods.
- 4) Finally, fourth-party multi-stakeholder codes of conducts that are enacted and monitored jointly by different agents are currently being developed by the Common Code for the Coffee Community (CCCC).

A detailed analysis of these initiatives would be beyond the scope of this paper. I will therefore limit myself to some general observations while pointing out some of the specific features of the CCCC. The CCCC seems worth looking at since as a voluntary institutional arrangement that involves both some of the largest roasters and trading companies (Sara Lee, Nestle, Volcafé and the Neumann Group), as well as major coffee producer associations and NGOs it constitutes a historical novelty. It has the potential of being adopted by a large

number of major industry players and thus leading to a change in business relations in the coffee sector as a whole. It also enjoys the backing by major governmental development organizations such as the German “Gesellschaft für Technische Zusammenarbeit” (GTZ).

Corporate standards as well as codes of conduct in general face some critical challenges: even when they provide for third-party verification, there is a danger of setting the requirements so low as having no meaningful impact on producers and/or the environment at all while free-riding on the reputation of sustainability labels established by Fair Trade or environmental NGOs and ultimately eroding the ability of the latter to provide benefits to producers. The concept of sustainability may then be watered down to mean only corporate sustainability, and not sustainability for the farmers. Approaches to price setting vary from one initiative to the other, from pure recommendations for a “sustainability differential” to a price to be negotiated and fixed in advance or to certain differentials above the current market price. The problem coffee growers risk is that under some schemes buyers demand from the producer that elevated standards be met as a precondition for doing business without offering adequate compensation that would enable the grower to meet these requirements (Lewin et al. 2004). This risk is very present in the case of the CCCC since with respect to producer prices it only stipulates the principle that “prices reflect the quality, including the quality of the product and the Common Code quality of sustainable production and processing practices”<sup>8</sup>. The criteria for acknowledging that the principle is being respected is that a “qualification process to establish a relationship between quality and price is established and quality is rewarded by a freely negotiated margin as agreed by the direct business partners”<sup>9</sup>. The combination of the market power of usually large buyers and inadequate market information available to producers leaves the latter to negotiate from a vulnerable position which threatens to diminish their economic sustainability. The fact that the Common Code does not emphasize

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<sup>8</sup> Common Code for the Coffee Community, 09 September 2004 Version

<sup>9</sup> Ibid.

producer protection but instead puts much of the onus for achieving sustainability and providing training and skill development on cooperatives and coffee estates has led the Fair Trade organizations to not endorse it. On the other hand, the CCCC has rather high environmental as well as social standards with respect to labor rights, potentially filling a gap in the Fair Trade system which does not incorporate plantations and estates and hence not the workers employed on them. The two systems may therefore be complementary, although the danger of further fuelling consumer confusion due to a proliferation of different labels and standards that may ultimately negatively affect demand for sustainable coffees overall should not be underestimated.

To what extent can the rapid development of industry initiatives be attributed to the Fair Trade movement? It is difficult to establish a causal relationship between the two phenomena, but the existence of the profitable and fast-growing Fair Trade niche together with negative publicity against the big mainstream companies has certainly exerted pressure on the latter to evaluate and to a certain degree adapt their practices. Retailer and brand initiatives are seen by the ISEAL Alliance (2004) partly as a response to the bottom-line impacts for businesses that participate in NGO-led labeling and certification schemes. The coffee industry itself expects sustainable coffees to become a strong rather than a marginal segment over the course of the next decade. This cautious industry optimism leads Giovannucci and Koekoek (2003) to speculate that they may become more of a competitive standard rather than a competitive differentiator in the future. However, if we take the developments in the context of the CCCC which yet awaits implementation as an indicator for such an evolution, it appears that the standard which the majority of the industry may converge on eventually will emphasize the environmental and quality dimensions more strongly and have only limited resemblance with the Fair Trade criteria.

In any case, with the entry of large commercial roasters in the sustainability realm, the distinction between the niche and the mainstream market is becoming more blurred (Ponte

2004). While the "long haul" strategy of Fair Trade entails that the niche becomes mainstream in the sense that their label grows at the expense of conventional coffee and/or by getting the commercial roasters to get their coffee certified by the Fair Trade National Initiatives, the outcome of the current process may also be a very different one: the mainstream could push out the niche by developing sustainability initiatives tailored to company PR needs that may gain acceptance by the consumer. They may either use certified codes of conduct with very low compliance costs and hence little benefits for producers, or preferred supplier systems with codes of conduct that do not entail any or only very low premium prices which only cover extra marginal costs and do not provide other direct benefits to farmers. Renard (2003) therefore speaks of a "reabsorption" of Fair Trade by the market as a real danger.

Against this background the issue of label proliferation and the ensuing risk of consumer confusion becomes ever more important. The parallel existence of third-party certified organic, shade-grown, and Fair Trade, as well as private "ethical" or "sustainability" labels already presents a challenge to Fair Trade at present. Particularly supermarkets indicate that they and their consumers would prefer a clear message and not to have to choose between different sustainable labels. In spite of considerable overlap between some of these schemes, each one is particularly strong on different dimensions which its proponents do not want to see watered down. The resistance against a sustainable "super-seal" is therefore rather high among the organizations concerned. While some producer cooperatives like Majomut advocate for one label since it would greatly cut transaction and certification costs for them, having to fulfill the requirements of all schemes also raises entry barriers for newcomers into the niche.

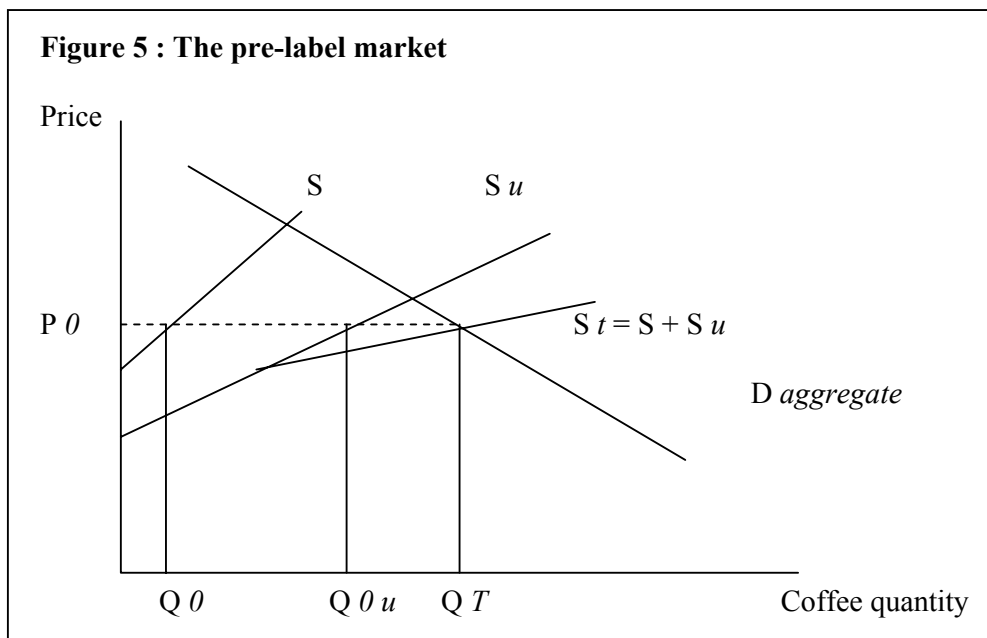
## **5. Fair Trade growth perspectives and limitations**

Although Fair Trade sales reached nearly 20% growth per year between 1999 and 2003, its global market share remains under 1% and has been estimated to never be able to exceed 5% of the total coffee market. Concern has also been expressed that a ceiling has been reached already in countries where the Fair Trade movement is better developed, e.g. in Denmark, the Netherlands and Switzerland (Giovannucci and Koekoek 2003). The effectiveness of Fair Trade as an instrument for development for a large share of small-scale producers and as a motor for a new type of trading relationships depends very much on its ability to market larger volumes of certified coffee. To increase the number of beneficiaries by increasing the number of Fair Trade consumers, the movement has generally two options : (1) to mainstream its marketing strategy and reduce final prices in order to aggressively enter the conventional market segment, or (2) to improve the quality of Fair Trade coffees to capture a larger market share in the specialty segment (Muradian and Pelupossy, 2004). Lewin et al. (2004) claim that there is now general consensus, also among some of its proponents, that to increase its volume and reach, Fair Trade must position itself strongly in mainstream distribution channels. This section seeks to provide a general framework for rethinking the structural conditions under which the scope of the system may be broadened to then assess the potential for different growth strategies given these constraints.

### **5.1 The effects of a sustainability label on supply and demand**

To be able to make a judgment on which strategy would make more sense, we have to be clear about the desired effects of voluntary sustainable certification schemes on the production and consumption of the labeled items. Generally speaking, a voluntary label aims to stimulate demand for the Fair Trade labeled item and create a price premium for it, assuming that consumers on ethical ground have a preference for the sustainable production

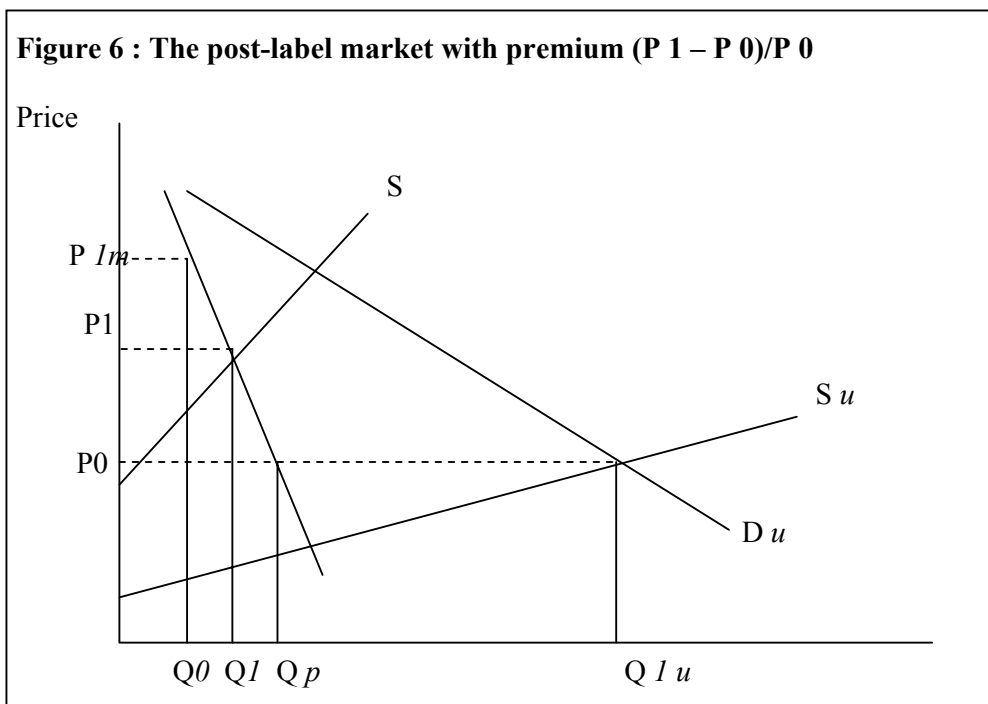
process. Underlying this labeling strategy is the assumption that an informational asymmetry exists between consumers and sellers about the way in which a product has been produced. The lack of an indication thereof prevents the consumer from distinguishing between various products and from expressing her preference for a credence attribute and the product incorporating it (see figure 5). Total supply ( $S_t$ ) consists of the supply of the product containing the credence attribute ( $S$ ) and the supply of the conventional product ( $S_u$  for “unlabeled”) mixed together. The demand curve is therefore also aggregated into demand for one single product. The price ( $P_0$ ) is the same for both types of coffee, leading to a quantity of the sustainable product  $Q_0$  and a quantity of  $Q_{0u}$  being sold and consumed.



Source: adapted from Larson (2003)

A label is supposed to remove this informational asymmetry. The ability of the consumer to identify the credence attribute differentiates the market into two separate markets that can clear at different price and quantity levels. It is the hope that the labeled product beco

mes more competitive compared to the conventional product which will lead to an increased supply of the labeled item (S shifts to the right) while reducing supply of the non-labeled one. Negative externalities like soil degradation or loss in biodiversity due to sun-grown coffee cultivation that result from conventional production methods would thereby be reduced (see figure 6). The price for the labeled product (P1) is higher than in the pre-label situation. This model has been developed by Mattoo and Singh (1994) and empirically tested by Larson (2003)



Source: adapted from Larson (2003)

It should be noted that conception ally the Fair Trade label does not entirely fit this idea which is based on credence attributes in relation to production methods. The idea of environmentally sustainable certification schemes is based on the fact that the market already contains a certain quantity of the product that is produced under the desired conditions without indicating On the other hand, according to the Fair Trade analysis its product, coffee that contains a decent price and favorable trading relationships for small-scale producers, does



not yet exist in the coffee market before the introduction of the certification mechanism. Whereas the sustainable coffee category that relates to production processes assumes that the removal of an informational asymmetry will suffice to stimulate demand and supply of the labeled product which previously existed, Fair Trade hopes to *create* a coffee product that has been produced and traded under fair and socially beneficial conditions. The analysis is however useful for determining the potential of Fair Trade in conjunction with other forms of product upgrading through organic or shade-grown production and should even apply to differentiation through taste attributes. As we have seen in the case of the cooperative La Unión Majomut, Fair Trade is often combined with sustainable production processes such as organic or shade grown. Indeed, in 2003, nearly 50% of Fair Trade labeled coffee was also certified organic. In this assessment and in much of the literature, some major merits of Fair Trade are linked to the role it plays for helping producers enter market segments where they are more likely to face conditions allowing for sustainable livelihoods. A meaningful evaluation of the perspectives for farmers in the Fair Trade system therefore has to include an examination of the long-term opportunities that exist in these other markets as well.

For these reasons, I will use the analysis which is adapted from Larson (2003) who examines the potential of a label for shade-grown coffee to bring about the results laid out above.

Where the equilibrium price and quantity of the labeled item lie depends on the elasticities of supply and potential demand for the credence attribute, i.e. the demand that exists for the labeled product if there was no price difference to the conventional product. If demand is quite inelastic, the market will produce higher price premia, but even minor positive supply responses will substantially diminish the resulting market price premium for the labeled item. The price may therefore vary between  $P_{1m}$ , assuming that there is no supply response at all and  $P_0$ , assuming that the ensuing supply response eliminates any price premium (see figure 6). While total coffee demand is quite inelastic as we have seen before, there is evidence for

high price elasticities for different coffee brands of around  $-3$  to  $-4$  (Krishnamuthi 1991; Bell et al 1999). With regards to various Latin Americans origins, long-run elasticities of substitution vary between  $-2$  to  $-5$  (Lord 1991). Larson (2003) calculates the elasticity for shade grown coffee to be in the same range which leads him to conclude that price premia will erode substantially as supply of the labeled item increases. There is therefore a certain trade-off between the positive environmental results of eco-labels which are only achieved by an increase in quantities of coffee produced sustainably and the social benefits in the form of price premia which are only maintained as long as supply does not shift strongly. Giovannucci and Koekoek (2003) equally note that price premia for organic coffees which have recently been substantial due to supply shortages and a surge in demand have already been decreasing. They expect them to go down further in the future until they only cover their marginal costs. The same logic may apply to gourmet quality coffees as some industry pundits point out that premia result from scarcity. For the near to mid term, however, even as more producers start growing these products, premia are likely to remain high since the US specialty coffee industry predicts continuing shortages of the coffees it requires. Differentiated coffees for which production processes can be duplicated like in the case of organic will have a greater risk of seeing their premia decline (Lewin et al. 2004)

## **5.2. Breakthrough via consumer education?**

For the Fair Trade system, these findings present a certain dilemma given that the minimum price to the producer narrows its range of options to increase sales volumes. A potential to help maintain prices is to raise total demand for the labeled product through consumer education about the benefits of the sustainably produced item. The model presented only shows the effect of market segmentation through price differentiation and only allows for movements along the demand curve for labeled coffee. With consumer education the demand

curve for the labeled items could shift out along with supply would shift, thereby maintaining price premia also in the future. It therefore seems reasonable that the Fair Trade movement plans to allocate more resources to advocacy activities in pursuance of this strategy. Adopting marketing and branding strategies similar to the ones of mainstream coffees may have a similar effect.

What are the Fair Trade's other options to increase its reach? They can be broadly divided into two different categories: 1) Reducing retail prices in order to aggressively enter the conventional market segment where competition takes place mainly on prices, or 2) to improve the reputation of the quality of Fair Trade coffees to capture a larger market share in the specialty segment (Muradian and Pelupessy, 2004). A reduction in final coffee prices without a concomitant reduction of producer prices would exploit potential demand (the demand for the Fair Trade product if prices were about equal to its conventional substitutes) more fully. Another way of putting these questions is to ask in which segments of the coffee market the chances of Fair Trade to reach additional consumers are greatest, and what activities could be pursued to be successful in either one.

### **5.3. The prospect for Fair Trade coffee in the mainstream market**

The term mainstreaming refers to the attempt to bring large actors that would normally operate in the conventional market into the Fair Trade system and to thereby reach a larger consumer population and to take advantage of economies of scale. If this strategy should result in lower retail prices for Fair Trade coffee, potential demand for Fair Trade coffee could be untapped.

Competing on prices would make sense if potential demand for Fair Trade coffee was large and if growth in the long run was limited by prices above market rates for conventional

coffee. Unfortunately, unlike for environmental credence attribute products, no data on the potential demand for Fair Trade coffee exist so far. On the other hand, although consumer motivations are considered to vary depending on the specific credence attribute purchased (health and environmental reasons for organic, social justice for Fair Trade), all sustainable coffees seem to appeal to a similar consumer segment which is relatively young, educated and economically well off and often show concern for both environmental and social dimensions. We may therefore assume similar potential demands when this segment of the population is expanding. In addition, according to data reported by Govindasamy and Italia (1998), 80 % of individuals claimed to be willing to purchase fresh produce grown using Integrated Pest Management methods, which is the case for Fair Trade coffee, although this fact may not be communicated very effectively and clearly to the consumer. Intuitively, in the absence of a price differential, there should be some willingness among customers to prefer a product that is perceived to incorporate generally accepted fairness criteria to a product which does not . We may therefore assume that potential demand for Fair Trade coffee is quite large. This last point could be taken as a good reason for the Fair Trade movement to pursue a strategy of mainstreaming its product and compete on prices as well as invest in consumer information.

There are several obstacles to this strategy, however. An inherent limitation for substantial price reductions is the question of the financial sustainability for the participating organizations and companies. The Fair Trade premium, especially in the form of a floor price when world prices are depressed, may compromise their profitability (IIED 2000). Their capacity to buy their coffee under Fair Trade conditions then falls which simultaneously reduces the value of price guarantees to producers. The recent FLO policy of shifting certification costs to the producer level could be seen as an attempt to address this problem. The rationale for this policy may well be the assumption that to be able to successfully compete in the mass segment based on prices, costs have to be cut somewhere. Reducing the

costs to licensees to adopt the Fair Trade label may be hoped to have an effect of their interest and ability to do so. The current over-supply within the Fair Trade system allows the FLO to reduce benefits to producers without officially violating its own standards, but reducing both the farmers' ability and incentive to enter or remain in the system. To prevent a reallocation of existing Fair Trade markets or supply chains, the FLO standards require the applicant to demonstrate that their registration will open up significant new markets for Fair Trade products and therefore will result in an increase in volumes sold.

A separate challenge for mainstreaming Fair Trade coffee lies in the difficulty of convincing mainstream processors to adopt the label since they generally do not see such a move as compatible with their overall brand management strategy. The inclusion of a sub-brand risks to call into question the conditions of trade and therefore the viability of their other brands. Furthermore, there is a tension between the altruistic value base underlying Fair Trade and its proposition as a mainstream business standard (IIED 2000). Finally, the Fair Trade system at present seems to simply lack control over final retail prices as we have seen before. One reason why Fair Trade has not been successful at bringing down retail prices in a number of markets may be the fact that to mainstream this coffee, the branding and advertising techniques prevailing in the conventional sector are being adopted which increases the non-coffee costs of the end product in the same way as for conventional brands. In practice, mainstreaming might therefore only consist of an effort to make Fair Trade coffee available to a larger segment of the population by marketing it through conventional distribution channels and by adopting conventional marketing and advertising strategies. For future growth in the conventional market, a paradigm shift towards branding, promotion and advertising strategies is deemed to be necessary by some industry pundits and analysts (Giovannucci and Koekoek 2003). A positive effect on Fair Trade sales would in that case rather reflect a success in shifting the demand curve for Fair Trade coffee up rather than a movement along the curve.

How effective are FLO's policies for increasing sales volumes through mainstreaming? When the Fair Trade movement started to invite mainstream importers, roasters and retailers to participate in fair trade under their newly launched labels from 1988 on, coffee attained wider distribution, and market share rose to as high as 2.5 - 3% in the Netherlands, Denmark and Switzerland and 7% of the ground coffee market in the UK (which however is only a minor portion of the total UK market where soluble coffees dominate). Muradian and Pelupessy (2004) contend that mainstreaming the marketing strategy has not been accompanied by a substantial price reduction. An important exception to this is the case of Switzerland where Fair Trade coffee is sold at retail prices that are only about 10% higher on average than those for conventional coffees while prices for double certified coffees are substantially higher (Giovannucci and Koekoek 2003).

### **5.3.1. Unintended side affects of mainstreaming?**

One possibility that would require further research is that Fair Trade only accomplishes its goal of reducing profits of operators in industrialized countries to the benefit of producers in markets where competition within the industry is strong already. If this was the case, the Fair Trade movement may be well-advised to reconsider its strategy of bringing large market actors into its system where the industry is very concentrated already.

On a more general level, it is unclear how important small price differentials actually are as a factor for inducing consumer purchases. Giovannucci and Koekoek (2003) refer to interviews in one country (not specified) that seem to indicate that having similar prices between fair trade and conventional coffees do not necessarily stimulate a significant increase in Fair Trade sales. Evidence pointing to potential demands if prices were similar to those of conventional coffees is therefore mixed.

While the effectiveness of mainstreaming Fair Trade is therefore uncertain, this strategy clearly produces some tensions with the underlying values of the Fair Trade system which have to do with distributional questions and to a lesser extent with the correction of market distortions. The new certification policy increases the entry barriers for producers and reduces the benefits for the ones that do participate. It aims at increasing the overall impact of the movement by making it more cost effective and thereby stimulating demand. While the entry of mainstream market actors may increase total Fair Trade sales, it simultaneously causes the market shares of smaller roasters and specialty retailers selling coffee under the same label to erode and may drive some out of the market. Fair Trade thus loses some of its impact on increasing competition at the nodes of the supply chain in consuming countries. The fact that the problem of high retail prices are unlikely to be solved by taking off the burden of certification costs from buyers and by transferring it to producers makes such attempts questionable and problematic from a development perspective.

#### **5.4. The quality strategy**

An alternative way of increasing Fair Trade sales is by raising the quality reputation of Fair Trade coffee to make it more competitive within a differentiated market. So far, while efforts at quality improvement in reality often go hand in hand with the participation in Fair Trade as we have seen in the case of Majomut, the quality of Fair Trade coffees in general is inconsistent and the Fair Trade Label is not necessarily associated with high quality at the consumer level at this stage. The current over-supply of coffee within the Fair Trade system combined with a shortage of high-quality supply of Fair Trade certified coffee that prevents companies from entering into a buying relationship with certified cooperatives makes the introduction of quality standards appealing. Concentrating efforts on the specialty market has the advantage that the demand in this sector is more inelastic and that competition is weaker

than in the conventional market, allowing for higher price premia that could also benefit agents in producing countries. It is also quite likely that there are consumers that are willing to pay high prices for coffee but are not willing to trade off taste characteristics for credence attributes. New demand for Fair Trade and other sustainable coffees could therefore be created among this customer segment.

#### **5.4.1. Side effects of standards**

It is not clear, however, if such standards would really have the desired effect: First, they may simply be irrelevant, imposing a development that market forces are bringing along by themselves anyway. The inability of cooperatives to sell all their coffee as Fair Trade together with increased access to market information on consumer and industry demand exerts pressure on producers to undertake quality improvement efforts. Buyers who have more to choose from can be expected to eschew poor quality. These assumptions are being confirmed by the experience of the cooperative Majomut. Second, the introduction of quality requirements might only work as a barrier to entry of the Fair Trade market for new producers and deprives them of the opportunity to learn about these market niches and to make efforts towards entering them. This is likely to exclude particularly small and marginalized producers and is at odds with the values of the Fair Trade movement. It may therefore not be too surprising that the FLO Strategic Plan for 2003-2008<sup>10</sup> does not contain any changes of its standards towards quality.

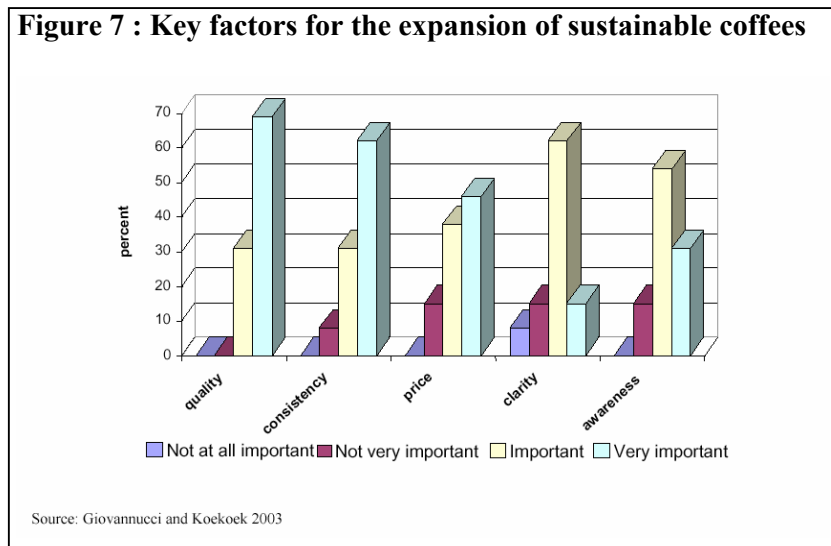
#### **5.4.2. Quality and consistency**

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<sup>10</sup> Accessed through [www.fairtrade.net](http://www.fairtrade.net), November 14, 2004



No matter which strategy will be pursued more vigorously by the Fair Trade movement, some constraints will apply at any rate given the structure of the market and the industry. With regards to the coffee industry, it is worth noting that in surveys both European and North American coffee companies indicated that coffee quality and consistency were the most important criteria for their decisions to purchase sustainable coffees, even more than price or customer awareness/demand.



The emphasis on consistency underscores the industry's typical preference for predictable and steady quality as well as for predictable and reliable business relationships due to the costs and risks involved with dealing with new suppliers. It has strong implications for smaller suppliers who find it most difficult to achieve consistency every year. As a competitive factor it affects the growth potential of Fair Trade coffee independent of the channel through which it would be marketed : consistency, even of lower-quality coffee, is important also in the mainstream market where large roasters work with low inventories for flexible blending.

### 5.5. Traveling different roads and building on integrated strategies

To summarize, increasing Fair Trade sales does not seem easy in the mainstream market due to limits for small-scale producers to provide large and consistent supplies that satisfy the buying requirements of large roasters and due to the current inability of the Fair Trade system to bring down retail prices. The prospects for increasing volumes in the high-quality segment of the market may generally be better, although technical difficulties exist and may not be easily overcome by measures such as establishing standards. Both mainstreaming measures that imply an increase in the participation costs of producers and quality standards will reduce the benefits of producers from selling through the FLO system. This effect may be offset by larger sales volumes of Fair Trade coffee to the extent that the strategies have an impact on Fair Trade demand. Efforts of mainstreaming and quality improvement may however not necessarily be mutually exclusive. Indeed, both strategies could be pursued simultaneously. The Fair Trade movement can emphasize its efforts to involve mainstream distribution channels such as supermarkets but not necessarily large roasters, offering a differentiated (and higher price) product via a mainstream channel. As competition increases among retailers offering Fair Trade coffee and as the system becomes more efficient, final prices would have a downward tendency. Instead of introducing quality requirements, FLO and its National Initiatives could try to encourage producers more strongly to invest in quality improvement and strengthen their ability to do so by channeling more resources towards such capacity-building. Donor support could equally be oriented towards quality-oriented training and investment. Companies operating under the FLO system that already command higher quality coffee may be able to communicate the quality along with the credence attributes more effectively to the consumer, thereby raising the quality reputation of Fair Trade at the same time. Even if mainstreaming may not result in a decline of retail prices in all circumstances, increasing advertising efforts by main industry operators may nevertheless result in an outward shift of total demand for Fair Trade coffee

## **6. Conclusion**

I started from the question what the potential for the Fair Trade certification scheme as a market-based and non-trade-discriminating policy instrument is for achieving the goals it has set for itself. Poverty alleviation, redistribution of wealth from market agents in consuming to those in producing countries and changing conventional business practices are all believed to be part of making the trading system more “fair” by making it work in favor of poor farmers in developing countries. In the light of current market failures in the coffee sector pertaining to imbalances in the trading chain as well as the failure of private markets to provide credit, information and risk management instruments to the actors in the chain who have the least access to them, the movement has to be given credit for coupling income support to a mechanism that targets these failures directly.

From the case study of Majomut, we can quite confidently conclude that participation in Fair Trade networks can bring significant socio-economic benefits both to individual producers and to the peasant communities that are members on a collective level. The importance of the price premium stretches beyond its income effect to the provision of an opportunity to get involved in both organic production and in quality improvement by enabling the cooperative to overcome the financial hurdle of high fixed costs both production techniques entail. The greatest value of Fair Trade may therefore lie in its ability to act as a catalyst for entering into activities that upgrade a cooperative’s coffee and allowing it to escape the low-quality/low-price coffee cycle prevailing in the conventional market. If a judgment on the effectiveness of Fair Trade and other sustainable coffees were made on the basis of their effects on producer prices alone, the result would appear more modest, taking into account the effects that certification costs have on producer benefits, and the effect of supply responses to premia for certified organic products, and maybe even on high quality coffees. Having examined the

cyclical nature of coffee markets and the structural changes in the global coffee industry, it becomes clear that an understanding of these factors is crucial for producers to thrive in this new business environment. The decrease of agricultural support from governments in producing countries shifts the onus of providing necessary services increasingly on producer and trade organizations. Fair Trade can make an important contribution as a mechanism for the extension of such services as well as of provision of market information and strengthen the bargaining power of producer cooperatives.

When assessing the Fair Trade claim to alleviate poverty and work with marginalized people we should not forget, however, that it helps those farmers most that are already comparatively well off because of being organized in a relatively strong and efficient cooperative. On the contrary, the most marginalised farmers in very remote areas will not be able to benefit from these initiatives. FLO does not intervene to strengthen weaker cooperatives to help them meet the requirements or take the initiative to organize remote and particularly marginalized farmers in new area, although some NGOs can take up such a role and successfully have in the past. An advantage of such a policy is that it prevents cooperatives from becoming financially dependent on the system (Milford 2004). The fact that under FLO policies larger scale farmers that might meet Fair Trade standards are not permitted to participate also implies that a high number of farm workers on large coffee plantations cannot be included. These landless rural workers may be among the poorest parts of the population. There is therefore a tension between the claim of helping the poorest and the aim to operate financially sustainable and improve efficiency. Another problem lies in the fact that shifting demand towards Fair Trade and away from mainstream coffee risks to further depress prices in the conventional market and have negative income effects on producers unable to participate in Fair Trade. The Fair Trade dilemma can be seen more broadly as a certain trade-off between the scope of its beneficiaries and the size of the benefits it can provide to these beneficiaries.

It may be most reasonable to see Fair Trade as complementary to other initiatives like the CCCC that have a stronger emphasis on labor conditions and wages. Only Fair Trade explicitly targets small farmers who are the ones that are most negatively affected by the structural changes in the coffee industry and will not necessarily be able to benefit from industry codes of conduct. At the same time, one cannot expect from Fair Trade as a market-based mechanism to help the poorest of these small-scale producers. This task will have to be left to public safety net programs. Governments should focus on rural development to increase competitiveness and reduce the dependency on a few primary commodities and to facilitate the transition of certain producers that are can be neither competitive in the mainstream nor in niche markets into other activities as well as to focus on to.

With regards to Fair Trade's goal of shifting profits to growers and away from large multinational corporations it notches up only partial successes. The differentiated market of which Fair Trade is one segment - and to other segments of which it facilitates entry- has been found to increase competition among companies in industrialized countries and to reduce the market share of their conventional brands. This may eventually challenge their trading and selling practices. However, there is a logical tension in the Fair Trade approach which seeks to both drive down profits for operators in industrialized countries by increasing competition and to make them change their business practices in response since such a change would be and is ultimately aimed at regaining lost market shares. A major failure of the Fair Trade system by its own standards lies in its current tendency to increase rents all along the supply chain instead of decreasing the ones of operators in consumer countries in most cases.

The final verdict on the transformation of the trading and commercial practices of the whole industry still has to await results on the direction in which industry initiatives may be evolving.

While the advocacy work of the National Fair Trade Initiatives as well as their commercial success had played a role in pushing major industry players to reconsider some of their business practices, it is not yet clear what form any future changes will take and what effect they will in turn have on the future of the Fair Trade system itself. There seems to be a positive trend towards business practices that favor direct buying and trading relationships, technical assistance and market information to help producers meet the needs of the industry and to some degree internalize social and environmental costs in the price of the end product. It seems highly unlikely however, that the Fair Trade standard in its pure form will become the mainstream code of conduct. Its ambition to operate successfully in a business environment it seeks to transform is bound to meet certain inherent limits. In the meantime, in spite of all qualifications, we ought not forget that the beneficial effects that Fair Trade has on small-scale producers in spite of some practical qualifications are very real and are probably the only hope for many individual farmers lacking other opportunities.

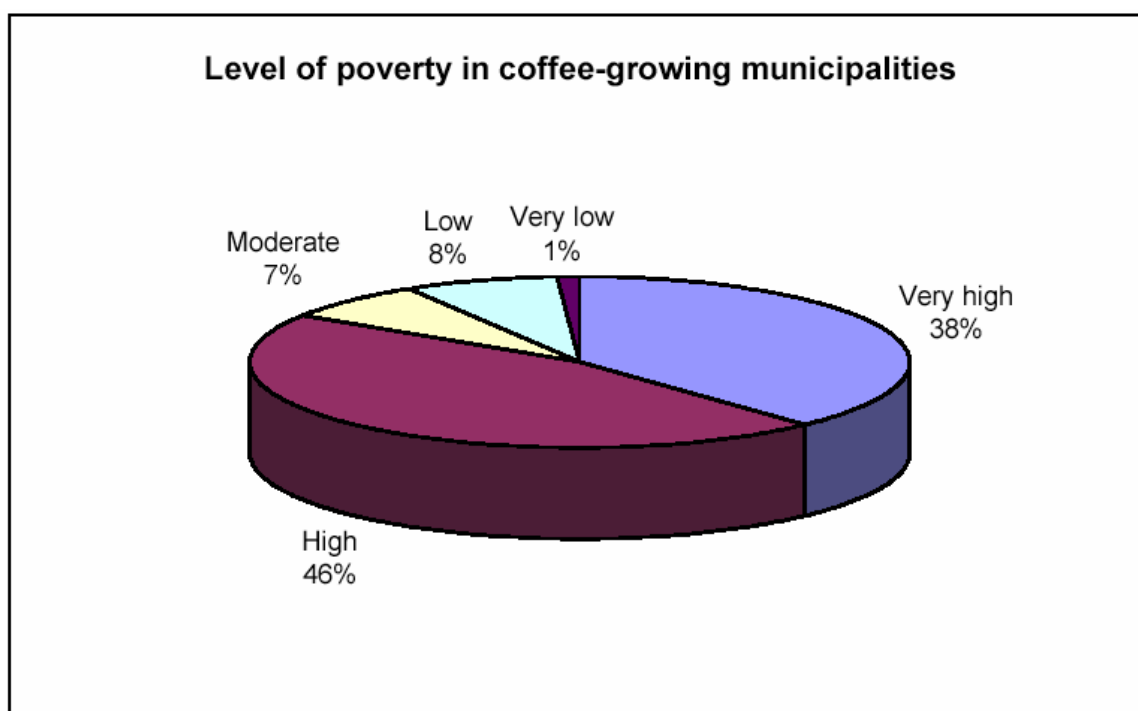
## Appendix

### Annex 1

**Levels of poverty in coffee-growing municipalities in Mexico (Source: Perezgrovas and Cervantes 2002)**

State	Very high	High	Moderate	Low	Very low	TOTAL
Colima				3	2	5
Chiapas	29	40	5	2		76
Guerrero	5	2	3	2		12
Hidalgo	12	11				23
Jalisco		3	1	5		9
Nayarit		1		7	1	9
Oaxaca	58	59	3	1		121
Puebla	24	23	1			48
Querétaro		1				1
San Luis Potosí	2	7				9
Tabasco			1	1		2
Veracruz	20	36	14	9	1	80
<b>TOTAL</b>	<b>150</b>	<b>183</b>	<b>28</b>	<b>30</b>	<b>4</b>	<b>395</b>
<b>%</b>	<b>38.0</b>	<b>46.3</b>	<b>7.1</b>	<b>7.6</b>	<b>1.0</b>	<b>100.0</b>

Hernández N., Luis y Teresa Ejea. 1996



Hernández N., Luis and Teresa Ejea, 1996

## Annex 2

**Table 1: Coffee Sold in the Conventional and Fair Trade Markets  
La Unión Majomut, 1992-2002 (69 kilogram sacks)**

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Harvest	Conventional Market <sup>1</sup>		Fair Trade Market <sup>2</sup>		Total
	Sacks	%	Sacks	%	
1992-93	4122	100	0	0	4000
1993-94	4269	94	250	6	4519
1994-95	5020	91	500	9	5520
1995-96	4509	89	500	11	5009
1996-97	4012	80	1000	20	5012
1997-98	502	40	750	60	1252
1998-99	2523	71	1000	29	3523
1999-2000	2508	50	2500	50	5008
2000-2001	514	10	4500	90	5014
2001-2002	0	0	6500	100	6500
<b>Average</b>	<b>2543.55</b>	<b>62.50</b>	<b>1590.91</b>	<b>37.50</b>	<b>4123.36</b>

Source: records of La Unión Majomut

Notes: 1) Both national and export sales

2) Includes both organic and non-organic coffee

With respect to organic and conventional coffee in the 2001/2002 season, Majomut commercialized:

Organic coffee: 5985 *quintales* (58.8%)

Conventional coffee: 4125 *quintales* (41.2%)

Total: 10,020 *quintales*



### Annex 3

Costs for a conventional middle-and large scale coffee producer in Veracruz. Yields are of approximately 20 quintals per hectare. Prices are quoted in US dollars

CONCEPT	Year 1	Year 2	Year 3	Year 4	Year 5 <sup>31</sup>
<b>Labour</b>					
Initial weeding	60	0	0	0	0
Clearing	80	0	0	0	0
Control of root system	240	48	24	24	24
Planting/replanting	80	12	6	6	6
Clearing (with machete)	45	60	60	60	60
Applying herbicides	18	18	18	18	18
Fertilising	12	24	24	24	24
Pruning and removing sucres from plants	0	30	24	24	24
Control of shade	24	12	12	12	12
Harvest	0	0	60	300	500
<b>Subtotal</b>	<b>559</b>	<b>204</b>	<b>228</b>	<b>468</b>	<b>668</b>
<b>Materials</b>					
Plants	700	50	25	25	25
Fertiliser	40	100	100	100	100
Herbicides	20	20	20	20	20
<b>Subtotal</b>	<b>760</b>	<b>170</b>	<b>145</b>	<b>145</b>	<b>145</b>
<b>Other costs</b>					
Transport of materials	40	100	100	100	100
Transport of plants	80	10	10	10	10
Transport of coffee	0	0	10	40	60
Miscellaneous (5%)	72	20	20	30	40
<b>Subtotal</b>	<b>192</b>	<b>130</b>	<b>140</b>	<b>180</b>	<b>210</b>
<b>Grand Total</b>	<b>1,512</b>	<b>504</b>	<b>513</b>	<b>793</b>	<b>1,023</b>

Santoyo et al. 1994, 55/updated in 2001

**Costs for small-scale organic farmer in Chiapas**

CONCEPT	Days of work	Total in US\$
Control of shade	6	18
Pruning	6	18
Control of roots	3	9
Elimination of unproductive plants	5	15
Fertiliser preparation	6	18
Soil conservation activities	6	18
Opening rotos	2	6
Re-planting	2	6
Clearing	16	48
Application of compost	12	36
Pest control	3	9
Harvest	80	240
“Wet” processing of cherries	15	45
Transport	0	5
Inputs (a)	0	10
<b>Total</b>	<b>162</b>	<b>501</b>

Costs for producing a quintal of (conventional export-quality) coffee, on the part of a small-producer cooperative, follow.

Costs	US \$ / Qq	%
Collection of the coffee	1.80	11.6
Dry-processing	0.84	5.4
Administration	4.83	31.2
Marketing	6.80	44.0
Financial	1.20	7.8
<b>Total</b>	<b>\$15.47</b>	<b>100.0</b>

(Majomut cooperative, Chiapas;  
2000-2001 harvest)<sup>36</sup>

<sup>36</sup> The following tables present a detailed description of all expenses by a Mexican producer cooperative (Union Majomut):

<b>Collection of the Coffee</b>		
Concept	Pesos/Qq	%
payment to the recipient	6.64	39.41
Transport	3.40	20.18
Insurance	2.65	15.73
Packaging	0.70	4.15
Electricity, Gas and Water	1.17	6.94
Labour	0.33	1.96
Maintenance of warehouse	0.94	5.58
Maintenance of vehicles	0.38	2.26
Repairs	0.64	3.80
<b>Total</b>	<b>16.85</b>	<b>100.00</b>

<b>Dry-Processing</b>		
Concept	Pesos/Qq	%
Electricity	2.53	31.98
Gratification	0.19	2.40
Labour	3.90	49.30
Maintenance of Roaster	0.01	0.13
Inputs	0.42	5.31
Miscellaneous	0.06	0.76
Packaging	0.80	10.11
<b>Total</b>	<b>7.91</b>	<b>100.00</b>

	Pesos/Qq	%
Administration		
Salaries and Wages	17.49	38.51
Electricity	0.06	0.13
Telephone	2.85	6.27
Accessories	1.49	3.28
Maintenance of vehicles	1.24	2.73
Paper and Office Equipment	0.60	1.32

miscellaneous	0.26	0.57
mailing	2.33	5.13
Other inputs	0.25	0.55
Insurance	1.50	3.30
Gas and Water	7.00	15.41
Maintenance of office Equipment	0.33	0.73
membership fees	1.39	3.06
Transportation	6.66	14.66
Consultants	1.08	2.38
Building maintenance	0.02	0.04
bank commissions	0.57	1.25
ISR	0.30	0.66
<b>Total</b>	<b>45.42</b>	<b>100.00</b>

<sup>37</sup> Cooperative cost = \$15.47 /quintal (or \$12.21/lb) . One quintal equals 57.5 kilograms, or 126.65 lbs.

Source: Perezgrovas et al (2002)

***(Note : There must be an error in the unit denominations: Cooperative costs would have to be \$12.21/quintal, not \$12.21/lb)***

## Endnotes

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