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IS FAIR TRADE IN COFFEE
PRODUCTION FAIR AND USEFUL?
EVIDENCE FROM COSTA RICA AND
GUATEMALA AND IMPLICATIONS FOR POLICY

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Cover photo: A Nicaraguan worker holds coffee picked on a Costa Rican plantation. iStock photos. All other photos taken by Colleen Berndt.

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EXECUTIVE SUMMARY

Proponents of Fair Trade claim it improves the lives of farmers in developing countries by providing them a higher sale price for their crops, allowing for a higher standard of living, and offering the opportunity to escape the vulnerability of poverty. Drawing on field work conducted in Costa Rica and Guatemala, the author examines the observed effects of Fair Trade and finds it is unclear whether Fair Trade actually delivers on its promise. Rather, it may actually harm the long-term interests of small farmers in high-cost production areas.

Some small farmers adopt Fair Trade primarily because it provides a cheap way to hedge against swings in market prices that would otherwise be unavailable to the poor. In other words, when the institutional environment does not provide the conditions for the development of complex contractual arrangements for all producers, Fair Trade can be a useful institutional surrogate.

In the long run, however, Fair Trade represents, at best, a Band-Aid solution to the problems a deficient institutional structure creates in coffee-producing countries. Reforming the institutional framework to foster entrepreneurship and trade can better address the main problems Fair Trade attempts to resolve, such as low pay for the poorest segment of the population and the erratic business cycle.

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INTRODUCTION

In 2002, Measure O, a ballot initiative in Berkeley, California, proposed banning within Berkeley the sale of all brewed coffee that was not Fair Trade, organic, or “Shade Grown.”¹ Berkeley was an ideal spot to try this novel initiative as the city workers were already drinking Fair Trade coffee. In 1999, disturbed by a documentary about the exploitation of coffee workers in South America, Shirley Dean, then Mayor of Berkeley, pushed through a regulation requiring the city government to buy only Fair Trade coffee.

Measure O ultimately failed, but Fair Trade and the belief in its benefits have only grown. In the years since its inception, Fair Trade has evolved from an unknown grassroots movement on the political fringe to a mainstream purchasing decision. As of March 2007, 586 producer organizations have been certified by the Fairtrade Labelling Organization, representing over a million farm workers in 50 countries around the globe.²

A distinction must be made here between the concept and goal of “fair trade” as socially conscious business practices used by those involved in an exchange and “fair trade certified” or “Fair Trade,” a set of specific business practices ordained by those organizations working under the umbrella of the Fairtrade Labelling Organization (FLO). This organization, based in Germany, certifies the producing organizations, and then other organizations, such as TransFair USA, certify the products for marketing purposes. The latter “Fair Trade” is the primary subject of this paper, though alternative methods of achieving “fair trade” as socially conscious business initiatives will also be discussed.³ Some of these alternative organizations offer their own distinctive labeling and have different producer requirements. Others are merely businesses that seek to satisfy the socially conscious consumer by carefully scrutinizing the business practices of their suppliers.

For its advocates, the purchase of Fair Trade products can be described as a charitable act. By encouraging minor, but voluntary, sacrifices for

¹ “Shade Grown” refers to coffee produced in an environmentally friendly manner that retains bird habitats.

² Fairtrade Labelling Organization, “Figures,” <http://www.fairtrade.net/figures.html>.

³ Non-Fair Trade producers object to the hijacking of this term as it seems to indicate that anything that is not “Fair Trade” reeks of exploitation, which is not necessarily the case. Certainly, this researcher found no evidence of exploitative practices at any of the non-Fair Trade Business visited.

the benefit of the poor in developing countries, Fair Trade makes a moral statement about the obligation of the “haves” to the “have-nots.”

Coffee, the world’s most widely consumed psychoactive drug, is the second-most traded commodity.⁴ More than 50 countries, primarily developing ones, produce it, and many of their economies depend heavily on coffee.⁵ For example, in 2000, coffee supplied Burundi, Ethiopia, and Rwanda with more than 50 percent of their total export earnings.

Developing countries produce the coffee; wealthy countries with well-developed markets consume it. According to the Coffee Research Institute, in 1999, U.S. coffee consumers spent over \$9 billion in the retail coffee market and an additional \$8 billion on coffee in the food service market. Approximately 54 percent of the U.S. population, more than 161 million people, consumes at least one cup of coffee daily. Eighteen percent of those, or approximately 29 million, drink specialty or gourmet coffee.

Given the prominence of coffee in the world economy, Fair Trade could, in theory, favorably impact the lives of millions of people, moving them further up the ladder of economic development. However, it is unclear whether Fair Trade

actually improves the lives of those it intends to help. At times, it may even harm the interests of small farmers in high-cost production areas. Some small farmers adopt Fair Trade because it provides a cheap form of hedging against swings in market prices that would otherwise be unavailable to the poor. In other words, when the institutional environment does not provide the conditions for the development of complex contractual arrangements for all producers, Fair Trade can be a useful institutional surrogate. Yet in the long run, Fair Trade represents, at best, a Band-Aid solution to the problems a deficient institutional structure creates in coffee-producing countries. Reforming the institutional framework to foster entrepreneurship and trade can better address the main problems Fair Trade attempts to resolve, such as low pay for the poorest segment of the population and the erratic business cycle.

In order to study the effect of Fair Trade, the author went into the field. This policy comment examines how Fair Trade operates in two Central American countries: Costa Rica and Guatemala. Costa Rica is Central America’s economic leader, with nearly double the GDP per capita of its next most prosperous neighbor, Belize, and nearly three times that of Nicaragua or Honduras. It is the third-largest coffee producer in Central America and, like many economically

⁴ Mark Pendergrast, *Uncommon Grounds: The History of Coffee and How It Transformed Our World* (New York: Basic Books, 1999): xv. Petroleum is the world’s most-traded commodity.

⁵ International Coffee Association, “Total Production of Exporting Countries,” <http://www.ico.org/prices/po.htm>

successful countries, struggles with issues regarding immigrant labor, most of which comes from neighboring Nicaragua.

Guatemala is the largest Central American producer of coffee, producing 40 percent more than its closest Central American rival, Honduras (Costa Rica is the third-largest producer).⁶ Guatemala struggles with a high level of corruption and strong ethnic divisions.⁷ In contrast to Costa Rica, only 60 percent of the Guatemalan population speaks Spanish. The other 40 percent speaks one of 21 different Mayan dialects. Guatemala's cultural divisions make it more representative of the other coffee-producing countries in Central America and therefore it presents a completely different institutional environment than that of Costa Rica in which to examine the effects of Fair Trade.

There are five sections in this paper. The first describes the market for coffee and relevant production processes. The second acquaints the reader with the coffee industry, Fair Trade requirements for that industry, and provides an overview of how Fair Trade and similar programs work. The third describes the Fair Trade experiences of Costa Rica and Guatemala, and how

they may apply generally. The fourth examines the effect of Fair Trade on the poor, and the fifth explains policy considerations.

A. THE PRODUCTION OF COFFEE AND COFFEE MARKETS

Historically, governments have used various price policies in attempts to stabilize production. At some level, Fair Trade coffee production also endeavors to stabilize market prices in order to provide a basic level of income for poor farmers.

A1. COFFEE QUALITIES AND THEIR MARKETS

A significant difference exists between commodity (or exchange-grade) coffee production and specialty coffee production.⁸ A homogenous product used in canned pre-ground supermarket coffees, exchange-traded coffee, also known as "C" market coffee, is sold as a commodity at the New York Board of Trade, similar to the ways in which gold or orange juice concentrate are sold.

Specialty coffees are of a higher grade. Because their value lies in their unique flavor characteristics or special production methods, they are not traded on the exchange as commodities. Instead, import and export operators negotiate privately

⁶ Statistics provided by the International Coffee Organization, http://www.ico.org/trade_statistics.asp.

⁷ According to Transparency International, Costa Rica's corruption perception score is 4.1 for 2006, as compared to 2.6 for Guatemala. A score below 5 represents "domestic corruption"; a score below 3 represents "rampant corruption." See http://www.transparency.org/policy_research/surveys_indices/cpi/2006/regional_highlights_factsheets.

⁸ The Specialty Coffee Association of America (SCAA) defines specialty coffee as that which "has no defects and has a distinctive flavor in the cup." See <http://www.scaa.org/pdfs/Press-What-is-Specialty-Coffee.pdf>.



Tiny roasting machines are used to roast samples of different coffees to determine the particular flavor qualities of each one.

for purchase with the coffee producers or producer organizations. Depending on differences in quality and flavor, retail prices of specialty coffees start at about \$8 per pound and go as high as \$25 per pound, with some retailing for \$150 or more per pound.⁹ Commodity coffee retails for much less, with brands such as Maxwell House and Folgers selling for approximately \$5 per pound.

The variety of coffee on the market reflects the range of growing conditions in coffee-producing countries. While specialty coffee thrives at higher altitudes in shaded, volcanic soil, commodity-grade coffee grows on flat, sunny expanses. Brazil grows mainly commodity-grade coffee, and because the terrain is less demanding, Brazilian

production can use mass cultivation and harvesting techniques. Such techniques position Brazil as the low-average-cost, large-scale producer. In contrast, Central American producing countries have ideal growing conditions for the finest grades of coffee, but experience higher average costs due to the exigencies of the mountainous terrain.

Fair Trade coffee falls into the specialty coffee market rather than the commodity market. Commodity coffee beans are not distinguishable from one another by growing process or origin; rather, they embody the primary characteristic of a commodity: one bean is essentially the same as the next. While it is generally of only slightly better quality than commodity-grade coffee, Fair

⁹ One pound of Arabica Luwak Coffee sells for approximately \$160 while the Robusta Luwak Coffee sells for \$120 per pound. This particular coffee has a rather distinctive milling process. Instead of being processed by the traditional wet or dry mills that refine most coffee worldwide, these beans are processed by passing through the digestive system of a palm civet, a small, cat-like animal indigenous to Southeast Asia.

Trade beans are distinguishable by their growing process. If Fair Trade coffee were to be sold on the commodity market, it would be mixed in with other coffees, prohibiting it from being sold at a Fair Trade premium. For this reason, Fair Trade coffee is sold as a specialty coffee.

A2. THE FAIRTRADE LABELLING ORGANIZATION'S PRICE MECHANISM

The FLO hopes to alleviate poverty and jump-start economic development through a mechanism called a price floor.¹⁰ As of June 2007, Fair Trade fixed a price floor of US\$1.21 per pound of green coffee beans, plus an additional US\$0.10 per pound premium.¹¹ The FLO also indexes that floor to the New York Coffee Exchange, so that should exchange prices rise above \$1.21 per pound, the Fair Trade price paid is always at least \$0.10 per pound over the market price.

The specialty coffee market comprises about 50 percent of the U.S. coffee industry,¹² with approximately 18 percent of the adult population consuming a daily cup.¹³ The dollar size of the specialty market in 2005 is estimated at \$11.05

billion worldwide, with the Fair Trade share of the world specialty coffee market being estimated at 4.3 percent, or approximately \$475 million.¹⁴ As shown in Figure 1, Fair Trade coffee is much more popular in parts of Europe than in the United States. Even so, sales of Fair Trade coffee do not make up more than five percent of the coffee market in any consuming country.

Although the relative size of the Fair Trade market is small, it is the fastest-growing segment of the specialty coffee industry, with total retail sales of Fair Trade-labeled coffee growing from less than \$50 million in 2000 to just under \$500 million by 2005. As the United States is the largest consumer of coffee worldwide—consuming 2.3 billion pounds of coffee annually—it is a relatively important market for Fair Trade.¹⁵ The United States purchased and imported approximately 22 percent of the world's coffee harvest from the 2005-2006 season. Hence, though Fair Trade coffee accounts for less than one percent of the current U.S. coffee market, even small market share gains are significant. In the U.S. market, Fair Trade is most popular in the major cities on the

¹⁰ A price floor is an imposed limit on how low a price can be charged for a product.

¹¹ On June 1, 2007, the per pound premium increased from US\$.05 to US\$.10. There is an additional premium for organically grown coffees.

¹² Specialty Coffee Association of America, "Specialty Coffee Factoids," <http://www.scaa.org/pdfs/specialtycoffeefacts.pdf>.

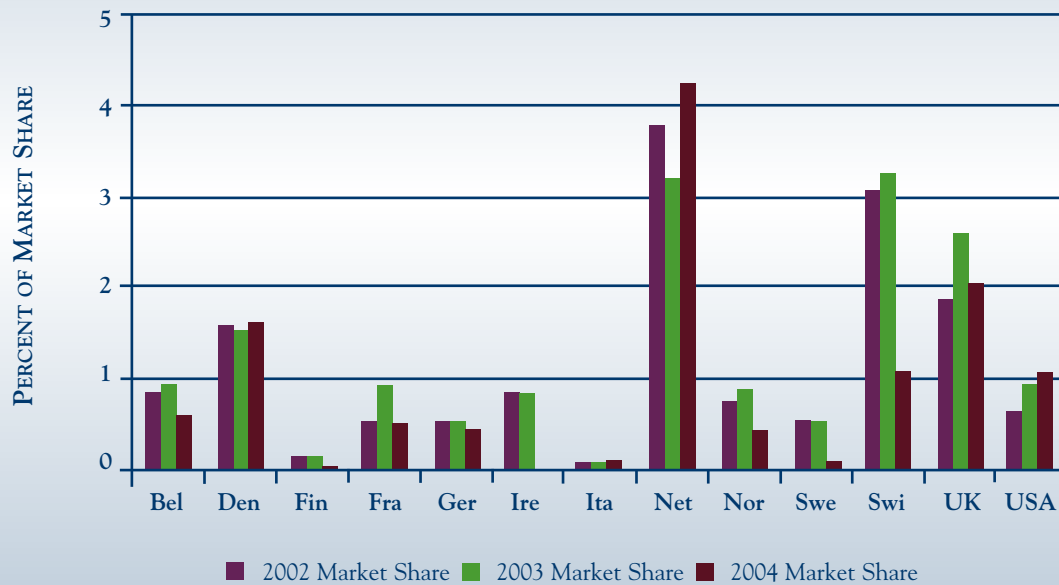
¹³ Coffee Research Institute, "Consumption in the United States," <http://www.coffeeresearch.org/market/usa.htm>.

¹⁴ Specialty Coffee Association of America, "Specialty Coffee Retail in the USA 2006," <http://www.scaa.org/pdfs/news/specialtycoffeeretail.pdf>; TransFair USA, "Fast Facts: Fair Trade Certified Specialty Coffee," http://www.transfairusa.org/pdfs/fastfacts_coffee.pdf.

¹⁵ Coffee Research Institute, "Important Statistics," <http://www.coffeeresearch.org/market/importations.htm>.

FIGURE 1

ESTIMATED FAIR TRADE PERCENTAGE OF LOCAL COFFEE MARKET FOR UNITED STATES AND EUROPE



Source: Fairtrade Labelling Organization

West Coast and in university settings. In spite of TransFair USA’s marketing efforts,¹⁶ much of the rest of the country’s population remains unaware of the certification.

The situation is different in Europe. Sales of Fair Trade-certified goods doubled between 2000 and

2005—primarily in the areas of bananas and coffee—in large part as a result of the growing number of commercial outlets carrying Fair Trade-labeled goods. Worldwide, sales of Fair Trade products have increased in the past two years—up 37 percent in 2005 after a 32 percent increase in 2004.¹⁷

¹⁶ “Paul Rice and his group have done an amazing job at convincing a small group of vocal and active consumers in America to be suspicious of anybody who isn’t FT.” Jeff Teter (president, Allegro Coffee), in discussion with the author, February 2007.

¹⁷ Fairtrade Labelling Organization, “Figures,” <http://www.fairtrade.net/figures.html>.

While demand for exchange-grade coffee, specialty coffee in general, and Fair Trade coffee in particular continues to rise, the coffee market remains extremely volatile and characterized by natural cycles. On average, coffee plants take from three to five years to reach maturity and full production capability. Depending on the variety of coffee, the plants' growth and production depends on the proper environment of either partial shade, temperate mountain air, and volcanic soil or hot and sunny plains. A frost can easily destroy the year's harvest, if not kill the plants themselves. When such a frost occurs, supply declines and prices rise. Even the threat of a Brazilian frost is enough to affect substantially the world price.¹⁸ Contraction in supply creates unusually high prices, and the resulting high profit margins produce an almost irresistible incentive for newcomers to enter the coffee business. In turn, the heavy cultivation of new coffee plants causes a predictable surplus of coffee in about five years, which drives down prices, causing great economic hardship to all those involved in the coffee industry. This effect is especially

potent for those countries whose economies rely heavily on this one agricultural product.¹⁹

Adding to the volatility are the market's supply and demand characteristics. Demand for coffee grows slowly and remains relatively stable over time.²⁰ Historically, coffee consumption has increased parallel to the growth of the population and the increase in the growing population's income. This implies a steady, gradual growth in demand.²¹ On the supply side, the coffee market is relatively inflexible. Coffee farming requires significant investments and long-term capital commitments that cannot be easily reallocated to other types of farming or production in down cycles. Due to these factors,²² production is relatively unresponsive to short-run changes in price. Farmers will continue to bring their stock to market so long as they are covering their per-unit production costs. While Brazil's biennial bumper crop generates some minor volatility, the real uncertainty in the coffee market results from destructive weather events such as frosts, droughts, or hurricanes.

¹⁸ Pendergrast, *Uncommon Grounds*, 63.

¹⁹ Brazil and, to a lesser extent, Columbia dominate coffee production. General Foods, Proctor and Gamble, Kraft, and Nestle are the major players in conventional coffee processing and sales, with some specialty coffee lines.

²⁰ Richard B. Bilder, "The International Coffee Agreement, 1962," *The American Journal of International Law* 57, no. 4 (1963): 888–892; Amy Farmer, "Information Sharing with Capacity Uncertainty: The Case of Coffee," *The Canadian Journal of Economics* 27, no. 2 (1994): 415–432.

²¹ However, in recent years, demand has risen more slowly due to the popularity of caffeinated beverages, such as Coca-Cola. See Robert H. Bates, *Open Economy Politics: The Political Economy of the World Coffee Trade* (Princeton, New Jersey: Princeton University Press, 1997); Amy Farmer, "The Case of Coffee," 415–432.

²² High fixed costs of capital include land and equipment specific to the milling of coffee; low per-unit costs include plants, fertilizer, water, and labor.



Farm worker Ricardo stands near a coffee plant at Doka Estate Coffee Farm.

A3. THE DESIRE TO STABILIZE PRICES

Because of the volatile nature of the coffee market, the FLO is not the first entity to attempt to stabilize the price of coffee. Almost all coffee-producing countries rely heavily on coffee exports as the primary source of income. Latin American countries derive nearly 25 percent of their export revenue from coffee.²³ Thus, producing countries have made numerous attempts over the years to moderate the business cycles. Brazil, whose share of world coffee production was in excess of 70 percent by the end of the nineteenth century,²⁴

promoted a number of valorization schemes²⁵ to protect its coffee industry. This golden age of valorization stretched from 1907 to the 1930s. Unfortunately, as is the nature with artificially maintained high prices, such schemes served only to encourage more production. Additionally, because cartels are notoriously difficult to sustain, cheating was rampant.

Although most cartels involve only sellers, the coffee industry has seen two cartel arrangements involving the United States, a major coffee-

²³ Bilder, “The Inter-American Coffee Agreement,” 328–391.

²⁴ Marcelo De Paiva Abreu and Afonso S. Bevilaqua, “Brazil as an Export Economy, 1880–1930,” in *An Economic History of the Twentieth Century Latin America, vol. 1: The Export Age: The Latin American Economies in the Late Nineteenth and Early Twentieth Centuries*, ed. Enrique Cardenas, Jose Antonio Ocampo, and Rosemary Thorp (Oxford: Palgrave and St. Antony’s College, 2000), 127–142.

²⁵ These valorization schemes consisted of a number of attempts to form stable producer cartels aimed at raising the sales price of coffee and thereby increasing the revenues earned by the producing countries. It was hoped that by providing stable prices, the producing countries could avoid the boom-bust cycle inherent in the coffee business. As is typical with cartels, enforcement of the agreements was difficult.

buying country. The first of these agreements arose in the 1940s as a way to provide stability during World War II. During the war, the United States assisted coffee-producing countries by buying large stores of coffee and shipping it to various parts of the globe. After the war, the agreement ended when a coffee boom made its renewal unnecessary.

With the rise of communism in developing countries, the United States found other reasons to involve itself in another cartel arrangement. By the 1960s, the United States feared the spread of communism in neighboring Latin America as the economies of those countries suffered. President John F. Kennedy signed the International Commodity Agreement (ICA) in 1962,²⁶ and articulated the situation in coffee-producing countries. “We are attempting to get an agreement on coffee because if we don’t get an agreement on coffee we’re going to find an increasingly dangerous situation in the coffee producing countries, and one which would threaten . . . the security of the entire hemisphere.”²⁷

While the ICA was detrimental to American consumers, the U.S. government saw it as less of an economic agreement than as a solution to the perceived leftist threat, demonstrating a clear trade-off between economic and political interests.²⁸ Any resistance to the ICA faded as the United States sought to ensure no other countries in Latin America followed Cuba’s lead. “This agreement is so great a contribution to international stability and international peace and to the anti-Communist struggle, that we must wonder why it is opposed,” opined New York Senator Jacob Javits.²⁹

In reality, the commodity agreement served as a type of foreign aid, providing for the transfer of resources from the primarily consuming countries in the Organization for Economic Cooperation and Development (OECD) to the developing producing countries.³⁰ The ICA raised prices for the consumer, but after several decades of intervention, poverty remained a fact of life in coffee-producing countries. Indeed, studies of the ICA

²⁶ The International Commodity Agreement (ICA) evolved as a means to stabilize the chronic price cycles and endemic instability of the coffee industry by using a quota system that limited the amount of coffee that could be exported to consumer countries, thereby artificially increasing the price level.

²⁷ President John F. Kennedy, “Statement by the President on the Signing of the International Coffee Agreement,” in *Public Papers of the Presidents of the United States: John F. Kennedy* (Washington, DC: GPO, 1962), 712.

²⁸ Robert H. Bates, *Open Economy Politics: The Political Economy of the World Coffee Trade* (Princeton: Princeton University Press, 1997).

²⁹ Proceedings and Debates of the 88th Congress, Senate. 88th Cong., 1st Sess., *Congressional Record*. (1963): 9053 United States Government Printing Office, Washington.

³⁰ 1963, Proceedings and Debates of the 88th Congress, First Session, *Congressional Record*. House of Representatives. United States Government Printing Office, Washington; Farmer, “Information Sharing with Capacity Uncertainty: The Case of Coffee,” 415–432; Irving B. Kravis, “International Commodity Agreements to Promote Aid and Efficiency: The Case of Coffee,” *The Canadian Journal of Economics* 1, no. 2 (1968): 295–317.

have shown that it had no effect on poverty reduction.³¹ With the fall of communism in 1989, the United States backed out of the ICA, rendering it impotent.

A commodity agreement like the ICA is one of the ways developing countries try to stabilize prices of their large export commodities.³² However, studies have shown commodity agreements that operate based on export restrictions, such as the ICA, may not achieve these goals due to the maneuverings of insiders that concentrate the benefits of the transfers on fewer, less needy groups.³³

While price stability has long been a goal of coffee-producing countries, past efforts focused on state diplomacy, negotiation, and government coercion. With Fair Trade, a different approach to stability has emerged, based on voluntary arrangements driven by consumers' concern for poor farmers' welfare. While the FLO differs from past coffee price stabilization attempts, its incentive structure is similar and so will create similar problems—especially because higher prices lead to more production, which eventually depresses the prices small farmers receive. As *The Economist* puts it:

Paying a guaranteed Fairtrade premium—in effect, a subsidy—both prevents this signal [of

overproduction] from getting through and, by raising the average price paid for coffee, encourages more producers to enter the market. This then drives down the price of non-fairtrade coffee even further, making non-fairtrade farmers poorer.³⁴

B. THE FAIR TRADE INDUSTRY

Fair Trade's rules cover artisans and farmers that produce a variety of goods, including coffee, tea, cocoa, bananas, sugar, honey, rice, flowers, cotton, and even sports balls. It operates through a certification process. As the only organization allowed to certify producers, the FLO requires producing organizations to comply with a “set of minimum standards for socially responsible production and trade.”³⁵ These standards (22 pages of general standards as well as an additional product-specific set of standards) detail member-farm size, electoral processes and democratic organization, contractual transparency and reporting, and environmental standards, to name only a few. The FLO is the only organization that certifies complying producers.

Other supporting organizations, such as TransFair USA, uphold the standards, certifying the products themselves and the intervening organiza-

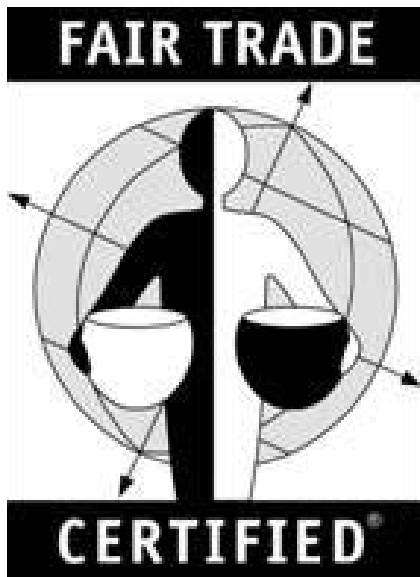
³¹ Mary Bohman, Lovell Jarvis, and Richard Barichello, “Rent Seeking and International Commodity Agreements: The Case of Coffee,” *Economic Development and Cultural Change* 44, no. 2 (1996): 379–404.

³² Kravis, “International Commodity Agreements to Promote Aid and Efficiency: The Case of Coffee,” 295–317.

³³ Bohman, Jarvis, and Barichello, “Rent Seeking and International Commodity Agreements: The Case of Coffee,” 379–404.

³⁴ “Voting with Your Trolley,” *The Economist*, December 7, 2006.

³⁵ Fairtrade Labelling Organization, “Generic Standards,” http://www.fairtrade.net/generic_standards.html.



TransFair USA's label. This Fair Trade certified label allows consumers to identify products that are produced and traded according to international Fair Trade standards.

tions that bring the product from the producer to the consumer. TransFair USA's label allows U.S. consumers to identify goods produced under the FLO's Fair Trade standards.

B1. THE FAIRTRADE LABELLING ORGANIZATION'S GOALS

The FLO states: "Fair Trade is a trading partnership, based on dialogue, transparency and respect, that seeks greater equity in international trade."³⁶ Fair Trade's overall goal is to provide a mechanism whereby consumers in rich countries can assist the craftsman or farmer in developing coun-

tries, and it claims that, "The best way to give small-scale producers in developing countries a real opportunity towards a better life is to give them a fair chance to produce and market their products."³⁷ Furthermore, TransFair USA states: "Fair Trade Certification empowers farmers and farm workers to lift themselves out of poverty."³⁸

Some of Fair Trade's goals for the coffee industry are to:

1. move marginalized producers and workers to a position of economic security and self-sufficiency;

³⁶ Fairtrade Labelling Organization, "About Fair Trade," http://www.fairtrade.net/about_fairtrade.html.

³⁷ Fairtrade Labelling Organization, "Annual Report," 2005, http://www.fairtrade.net/uploads/media/FLO_Annual_Report_01.pdf

³⁸ TransFair USA, "Fair Trade Overview," <http://www.transfairusa.org/content/about/overview.php>. Marketing departments of major companies use Fair Trade coffee to signal their socially conscious proclivities to consumers. For example, Dunkin' Donuts partnered with TransFair USA in October 2005 to promote Fair Trade Month. The company has been using Fair Trade coffee since 2003 in an effort to "help farmers in coffee producing regions." Dunkin' Donuts, "Dunkin' Donuts Partners with TransFair USA in Support of National Fair Trade Month," press release, October 13, 2005.



This is an example of a Micromill, a tiny version of a milling facility, on an individual farm at Biocafe Oro Tarrazu. By owning and operating their own mill, Biocafe can capture any profits from the coffee milling operation.

2. empower producers as stakeholders in the milling segment of the business; and
3. work towards greater equity in international trade.³⁹

Fair Trade attempts to achieve its first goal of economic security through the use of a voluntary price floor. High coffee prices during boom cycles encourage excess production, which later results in excess supply and a bust cycle. Fair Trade seeks to moderate fluctuating price cycles, decreasing the downside risk to the producer. In effect, Fair

Trade operates as a very simple hedging device for small farmers.

The FLO's second goal seeks to give farmers more control over the milling operation. Historically, small farmers who often farm in remote areas had to rely on (sometimes unscrupulous) middlemen (called "coyotes") to bring their harvest to the mill in a timely manner to prevent spoilage. The FLO attempts to overcome this problem by requiring Fair Trade farmers to belong to cooperative mills that send out trucks to the farm areas to collect the harvest, thereby reducing the need for middlemen.⁴⁰

³⁹ Fairtrade Labelling Organization, "About Fair Trade," http://www.fairtrade.net/about_fairtrade.html.

⁴⁰ The vulnerability of farmers has also been reduced due to better communications and better roads. In Guatemala, for example, market information is sent daily (or more often) to farmers via broadcast phone text messages. In Costa Rica, price information is published in the local newspapers. In both of these countries, some small farmers have invested in their own "micromills" so they can capture the profits of this second step. William Hempstead (director, Anacafe, Guatemala), in discussion with the author, November 2006.

As for its third goal, greater equity in international trade, the FLO is not specific about what constitutes greater equity, nor is the idea incorporated into its rules in a concrete, measurable manner.⁴¹

B2. THE FAIRTRADE LABELLING ORGANIZATION AND COFFEE

When it comes to coffee, the FLO certifies the cooperatives in each country, not individual coffee farms. Interested farmers join a Fair Trade-certified cooperative to which they can sell their harvests. The cooperative is responsible for ensuring that individual farmers adhere to Fair Trade production standards, but the farms themselves are not certified. In order to receive FLO certification, the producer cooperative must pay between US\$2,000 and US\$4,000 to the FLO. For a cooperative to maintain certification, it must undergo an annual inspection, for which there are additional fees. These inspections range from simple visits to requests for cooperative documents for a remote inspection.

Fair Trade rules are very detailed as to what specifications a farm or cooperative must meet in

order to maintain its certification. Fair Trade coffee farms “are not structurally dependent on permanent hired labour, managing their farm mainly with their own and their family’s labour-force.”⁴² Plantation-style farms—the mainstay of Brazilian coffee production—are ineligible for Fair Trade certification as they are too large. The same is true for small farms which just exceed the five hectare (12 acre) maximum allowable size. Additionally, a coffee farm is not eligible for Fair Trade certification if it employs even one person as a permanent full-time employee.

During the seven-to-eight-month growing season, an average family can tend to its farm quite easily. However, during the harvest (November to March), the family needs large numbers of seasonal employees to bring in the crop.⁴³ These seasonal employees are often migrant farm workers who go from farm to farm, picking the ripe coffee berries for the owners. While Fair Trade rules specify these workers be paid at least minimum wage, the FLO does not inspect the business practices of individual farms. Its inspections take place only at the level of the cooperative.

⁴¹ In actuality, farmers already have increased access to international markets. As the market for specialty coffee has grown over the past several years, large companies, such as Starbucks, have representatives in each coffee-producing country who seek out the best quality coffee in their regions.

⁴² Fairtrade Labelling Organization, “Generic Fairtrade Standards For Small Farmers’ Organizations,” http://www.fair-trade.net/fileadmin/user_upload/content/Generic_Fairtrade_Standard_SF_Dec_2005_EN.pdf

⁴³ The traditional ‘summer vacation’ for schools in coffee-producing countries coincides precisely with peak of the harvest. Traditionally, picking the ripe coffee berries is a job that teenagers can do to earn money during school vacation. Seasonal workers, who are unable to afford child care, often bring their young children to play in the fields where they can be watched. Fair Trade regulations, however, prohibit child labor, and so children are not generally allowed on Fair Trade farms during the harvest, imposing a higher cost on the laborer.

Fair Trade rules specify that, in order to receive a Fair Trade designation on their beans and the Fair Trade price, the individual farmers must sell their beans to a Fair Trade cooperative.⁴⁴ No other purchasers, such as multinational corporations or private, locally owned mills, are eligible for certification as a Fair Trade organization. The cooperative, in turn, must employ democratic procedures to determine the cooperative's leadership. The cooperative members elect leaders from within their ranks, and the cooperatives must demonstrate "transparent administration." This transparent administration ensures that members have sufficient information, such as contract prices and accounting information, to determine whether the cooperative is spending its funds according to the wishes of the membership. (Theoretically, members may opt to use the funds to build schools or medical clinics, hold them as emergency funds for which members can apply in times of need, or disburse them to the member farmers.) The cooperative must maintain these

records and make them available to the FLO during annual inspections. Transparent administration also allows members to set the salaries of the cooperative's administrative leaders.

C. THE EXPERIENCES OF COSTA RICA AND GUATEMALA

By and large, Costa Rica produced nearly two million 100-pound bags of coffee each year during the 2000-2006 time period (see Table 1).⁴⁵ Of that, less than two percent was sold as certified Fair Trade coffee.⁴⁶ In fact, over the past 10 years or so, the amount of Fair Trade coffee sold by Costa Rican farmers rose above two percent only once (in 1996 at 2.08 percent).⁴⁷ Guatemala's sales of Fair Trade coffee constitute only 2.21 percent of its production.⁴⁸

These figures might seem surprisingly small given TransFair USA's assertion that any farm wishing to be certified as a Fair Trade farm need only

⁴⁴ Farmers do not have to sell to the cooperative exclusively. They are free to sell their beans to other buyers at the non-Fair Trade market price and frequently do.

⁴⁵ A bag containing 100 pounds of coffee is called a "quintal." This is the measurement that farmers routinely refer to as selling for "one forty" meaning \$140, which is also why a pound of coffee is sold for "one forty" meaning \$1.40. However, it should be noted that a "bag" also refers to a 132-pound sack. For purposes of this paper, the author refers to the quintal. Data obtained from the *International Coffee Organization* Web site, <http://www.ico.org/prices/po.htm>.

⁴⁶ Carlos Alfaro (director, F. J. Orlich and Brothers, Costa Rica), in discussion with the author, June 2005. This was confirmed by data provided by Rolando Chacon Araya (technical services unit chief, ICAFE, Costa Rica).

⁴⁷ Data provided by Rolando Chacon Araya, (Technical Services Unit Chief, ICAFE, Costa Rica).

⁴⁸ Data provided by Gerardo Alberto de Leon (manager, Fedecocagua, Guatemala), in discussion with the author, November 2006.

TABLE 1

COSTA RICA TOTAL COFFEE PRODUCTION CROP-YEARS 2000-2006 ('000 BAGS)

	2000	2001	2002	2003	2004	2005	2006
	2,293	2,127	1,893	1,783	1,887	1,823	1,808

Source: Data from the International Coffee Organization Web site

apply to a cooperative for certification.⁴⁹ However, there are a number of constraints on the expansion of the Fair Trade market. The following larger costs and constraints associated with becoming Fair Trade certified may explain the low numbers of Fair Trade coffee sales.

1. Despite years of marketing, demand for Fair Trade coffee is rather low. For this reason, producers understand they must bring a buyer with them in order to join an established Fair Trade cooperative.
2. Fair Trade tends to fix prices at an artificially high level for the quality of the beans. Thus, there is a surplus of Fair Trade coffee on the market for which there is no buyer.

3. Many Fair Trade cooperatives are in areas where conditions are not favorable for growing high-grade coffee.
4. The benefits of becoming Fair Trade certified (the Fair Trade Premium) remain minimal.
5. The costs of Fair Trade certification can be very high, far more than the certification and inspections fees alone indicate.

C1. THE DEMAND FOR FAIR TRADE COFFEE

As robust as the growth in Fair Trade coffee appears, consumer demand lags well behind supply. This excess supply results in price drops, unsold inventories, or the sale of the Fair Trade-

⁴⁹ Michael Keaton (certification associate, TransFair USA), in discussion with the author, June 2005. While entry into the Fair Trade business is open to any cooperative willing to meet the requirements, farmers wishing to gain membership into a Fair Trade cooperative face long wait times unless they are able to bring a Fair Trade buyer with them, according to Tom Kilroy (co-founder, Contra Café, New Hampshire), in discussion with the author, June 2005. Additional suppliers of Fair Trade coffee mean the premium from low sales volume must be spread over more producers.

grown coffee on the open market as conventionally grown specialty coffee.

Producers and retailers continue to talk about lack of demand for Fair Trade coffee, as well as the oversupply. A recent guest columnist in the *Seattle Times* wrote, “In fact, the problem is not that these coffee companies are opposed to fair trade, but that we, as consumers, don’t demand it.”⁵⁰ Would-be Fair Trade producers report being told that they can only become Fair Trade-certified if they bring a buyer with them.⁵¹

Existing Fair Trade cooperatives are unable to sell their farmers’ entire harvests to Fair Trade buyers. Fedecocagua, the largest Fair Trade certified cooperative in Guatemala, reports it can sell only 23 percent of its production to Fair Trade buyers.⁵² Coo cafe, the top-level certified Fair Trade cooperative in Costa Rica, is composed of smaller cooperatives, whose members are the land-holding farmers. Average individual farmers report they can sell only approximately 20 percent of their farms’ coffee as Fair Trade, because there are simply not

enough buyers. They sell the remaining 80 percent of their harvest in the non-Fair Trade specialty coffee market.⁵³ One exception to this rule is Coope Llano Bonito, a mid-level cooperative, which sells approximately 40 percent of its cooperative’s harvest to Coo cafe as Fair Trade (See Table 2).⁵⁴

C2. LOCATION, LOCATION, LOCATION

Besides the high percentage of beans it sells as Fair Trade, Coope Llano Bonito is unusual among Fair Trade producer organizations in Costa Rica for another reason. It is the only cooperative located in the prime coffee-growing area of Los Santos, which has some of the best growing conditions in the country and produces some of the country’s highest quality coffee.⁵⁵ All of the other Fair Trade cooperatives are located in the Zona Norte, a suboptimal production area. Coffee grown there tends to be of lower quality due to poor growing conditions. This is why Llano Bonito’s high Fair Trade sales are not a surprise. Roasters use Llano Bonito’s higher-quality coffee beans to improve the flavor of the Fair Trade coffee coming out of Costa Rica.

⁵⁰ Alvaro Ramazzinni and Angelina Snodgrass Godoy, “A Fair Trade Port in the Storm,” *Seattle Times*, November 9, 2005.

⁵¹ The gatekeepers in this particular case are the established, certified cooperatives who do not proffer membership.

⁵² Gerardo Alberto de Leon (manager, Fedecocagua, Guatemala), in discussion with the author, November 2006.

⁵³ Drinking Fair Trade coffee means there is a fair chance one is drinking coffee made from 100 percent certified Fair Trade beans. Because most producers can’t sell entire crops as Fair Trade and must sell the remainder in the open market, if one drinks non-Fair Trade specialty coffee, it may well be made at least partly from beans produced under Fair Trade standards, but which were not purchased at the Fair Trade price.

⁵⁴ Jorge Ortiz Mora (technician, Coope Llano Bonito, Costa Rica), in discussion with the author, July 2005.

⁵⁵ Another large cooperative in the Los Santos area was in the process of becoming Fair Trade certified, but had not completed the process as of July 2005.

TABLE 2

**COOCAFE R.L.
DISTRIBUTION OF SALES BY HARVEST: FAIR TRADE
MARKET AND COMMERCIAL MARKET SUMMARY**

HARVEST	Fair Trade		Commercial		Total
93/94	42,300.00	55%	33,983.00	45%	76,283.00
94/95	39,498.00	57%	30,393.00	43%	69,891.00
95/96	44,327.00	52%	41,179.15	48%	85,506.15
96/97	28,980.00	48%	30,962.83	52%	59,942.83
97/98	34,950.50	49%	36,171.97	51%	71,122.47
98/99	34,976.50	58%	25,744.88	42%	60,721.38
99/00	26,230.35	29%	63,074.25	71%	89,304.60
00/01	30,557.00	46%	36,081.00	54%	66,638.00
01/02	31,206.00	41%	44,289.00	59%	75,495.00
02/03	35,827.50	42%	49,839.50	58%	85,667.00
03/04	36,352.50	47%	40,515.50	53%	76,868.00
TOTAL	348,852.85	48%	391,718.58	52%	740,571.43

Source: Data provided by Coo cafe⁵⁶

Roasters acknowledge that the quality of Fair Trade coffee, while usually better than exchange-grade, is often not as high as they might like.⁵⁷ Part of the quality problem is that, as in Costa Rica, the majority of the Fair Trade cooperatives

are in areas ill-suited for prime coffee growing. “Fair Trade directs itself to organizations and regions where there is a degree of marginality . . . we’re talking about unfavorable climates [for coffee production] . . . regions which are not

⁵⁶ The data provided by Coo cafe show the cooperative selling nearly half of the harvest as Fair Trade. This data contradicts the information gathered from farmers and other members of the industry in interviews, where they contend that most farms can only sell 20–40 percent of their harvests at the Fair Trade price. The author can find no explanation for this discrepancy.

⁵⁷ Jim Reynolds (roastmaster emeritus, Peet’s Coffee and Tea), in discussion with the author, April and July 2006; Steve Brown (buyer, Quartermaine Coffee), in discussion with the author, April 2005.



Good quality coffee beans, once milled and before they are roasted, are an even greenish-beige color, like the beans on the right. The beans on the left are of very poor quality, having lots of defects.

competitive,”⁵⁸ explains Dean Eliecer Ureña Prado of the School of Agricultural Economics at the Universidad de Costa Rica. The farms in these less optimal growing areas are not able to compete with the farms located in prime coffee-growing areas. Fair Trade allows these farmers to remain in the coffee business, and perhaps even prosper. However, the owners of these farms often already work in other industries in order to survive.

C3. A THREE-CENT BENEFIT?

As discussed above, the main mechanism through which Fair Trade hopes to alleviate poverty and jump-start economic development is through a price floor. Also detailed above, the

U.S. government once attempted this on a global scale, hoping to contain communism. The ICA did raise prices for the consumer, but after several decades of intervention, poverty remains a fact of life in coffee-producing countries. While both the ICA and Fair Trade result in higher prices for the consumer, the extra premiums paid do not necessarily accrue to the poorest segment of the coffee farming community. Indeed, studies of the ICA have shown no effect on poverty reduction.⁵⁹ Fair Trade, by utilizing a similar but direct mechanism, hopes to do through private markets what governments could not do through market intervention. While Fair Trade is to be applauded for not restricting consumers’ choices, the outcome

⁵⁸ Eliecer Ureña Prado (dean of the School of Agricultural Economics, Universidad de Costa Rica), in discussion with the author, July 2005.

⁵⁹ Bohman, Jarvis, and Barichello, “Rent Seeking and International Commodity Agreements: The Case of Coffee,” 379-404.

may not achieve what proponents of the method claim.

As in other Central American countries, production costs in Costa Rica and Guatemala generally do not exceed US\$0.90 per pound.⁶⁰ Because Fair Trade guarantees a price floor of US\$1.21 per pound, plus a US\$0.10 premium, Fair Trade provides the producer a profit of US\$0.41 per pound. Were it not for this guaranteed price, say Fair Trade advocates, most coffee farmers would be forced out of business, because the spot price on the NY Coffee Exchange (which reflects the price of exchange-grade coffees) fluctuates dramatically—reaching as low as US\$0.45 cents in October 2001.⁶¹

As Figure 2 indicates, Fair Trade prices are well above the commodity exchange prices.⁶² However,

most of the coffee produced in Costa Rica, Guatemala, and many other Central American countries is specialty coffee,⁶³ not exchange-grade commodity coffee. Indeed, Transfair USA admits they have not yet been able to find a way to compete in the price-sensitive commodity coffee market.⁶⁴ Thus, it is more realistic to compare the Fair Trade price to the price of specialty coffee, as is shown by Figure 3, rather than to compare the Fair Trade price to the price of commodity coffee.

From January 1989 to June 2006, the average price of coffee sold as Fair Trade was US\$1.36 per pound.⁶⁵ While the price of exchange-grade coffee was US\$1.03 per pound, the price paid for specialty coffee was generally US\$.30 per pound more,⁶⁶ and specialty coffee prices over this same period averaged US\$1.33 per pound. Thus, the real price benefit of Fair Trade for this period was

⁶⁰ Mireya Jones (board member and chair of Marketing and Communications, Specialty Coffee Association of America and owner of Finca Dos Marias, Guatemala), in interview with the author, October 2006; William Hempstead (director, Anacafe, Guatemala), in discussion with the author, November 2006.

⁶¹ While the spot price for commodity coffee is completely different than the prices obtained for specialty coffee, the two prices do tend to rise and fall in the same cyclical patterns and by similar magnitudes. The effect of this correlation is that as prices of all coffees rise, the extra amount a buyer would have to pay for specialty coffee diminishes as a percentage of price paid. In other words, specialty coffees become relatively cheaper. As such, one might observe an increase in the quantity of specialty coffee consumers buy as the spot price rises. That subject, however, is beyond the scope of this paper.

⁶² The Fair Trade certified price during the time period depicted in this figure was US\$1.21 with a premium of US\$0.05. The premium was raised to US\$0.10 as of June 1, 2007.

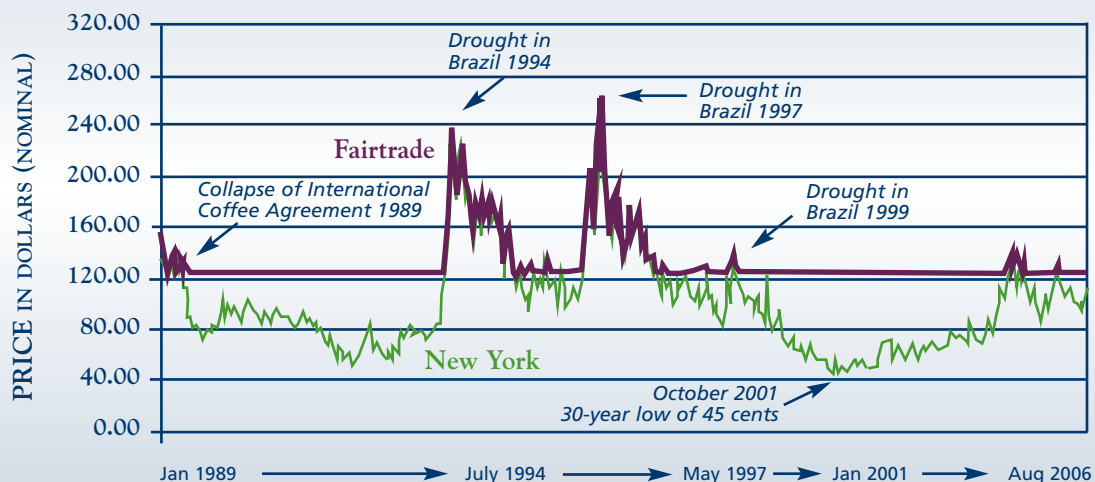
⁶³ Mauricio Cercone (executive director, Specialty Coffee Association of Costa Rica), in discussion with the author, June 2005, and William Hempstead (director, Anacafe, Guatemala), in discussion with the author, November 2006.

⁶⁴ Michael Keaton (certification associate, Transfair USA), in discussion with the author, June 7, 2005.

⁶⁵ It is important to note that the minimum Fair Trade price is \$1.26 per pound. However, because a premium is added whenever the spot price on the Exchange reaches \$1.21 or more, the price paid at any given time can be higher. For example, in January 2006, the spot price was \$1.24; the Fair Trade price for this period would be \$1.29.

⁶⁶ Mauricio Cercone (executive director, Specialty Coffee Association of Costa Rica), in discussion with the author, June 2005.

**THE ARABICA COFFEE MARKET 1989-2006:
COMPARISON OF FAIR TRADE AND
NEW YORK EXCHANGE PRICES**



NB Fairtrade minimum price = 121 cents/lb + 5 cents/lb premium.
When the New York price is 121 cents or above, the Fairtrade price = New York price + 5 cents.

Source: Graph courtesy of the Fairtrade Foundation⁶⁷

approximately three cents a pound, not the \$.33 that Fair Trade advocates claimed.⁶⁸

However, the actual benefit isn't really three cents on the pound, because the use of the price

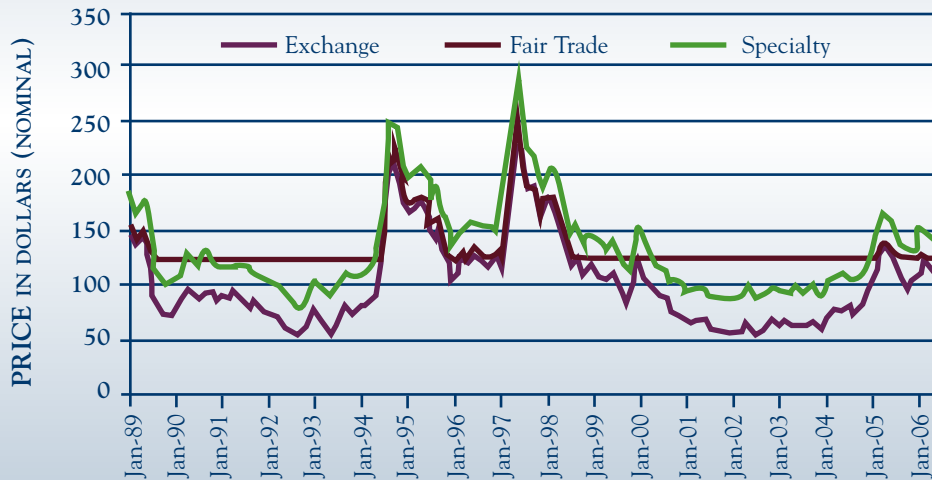
floor mechanism and the resulting premium create unintended consequences that result in the actual premium being larger than the \$.03 while decreasing the quality of Fair Trade coffee. Because of the low demand, the farmers can

⁶⁷ Fairtrade Foundation, "The Arabica Coffee Market 1989-2007: Comparison of Fairtrade and New York Prices," http://www.fairtrade.net/fileadmin/user_upload/content/Arabica_Price_Chart_89-07.pdf.

⁶⁸ The \$.33 benefit is calculated by subtracting the average price of exchange-grade coffee from the average price of coffee sold as Fair Trade (\$1.36-\$1.03 = \$.33).

FIGURE 3

**THE ARABICA COFFEE MARKET 1989-2006:
COMPARISON OF FAIR TRADE, NEW YORK
EXCHANGE, AND SPECIALTY PRICES**



Source: Data provided by the International Coffee Organization, the Specialty Coffee Association of Costa Rica, and producer sources in Costa Rica ⁶⁹

generally only sell a portion of their harvest as Fair Trade at the fixed price. The rest of the harvest must go to the open market, where price is a function of quality. There exists then a theoretical incentive for the farmer to sell the worst quality coffee as Fair Trade, saving the

better grades to collect a higher price on the open market.⁷⁰

While Transfair disputes that Fair Trade coffee is not a high-grade specialty coffee, they acknowledge that farmers do tend to sell the best of the

⁶⁹ Price data for the exchange grade coffee was obtained from the International Coffee Organization and includes only the price of non-Colombian Arabica coffee, the type grown throughout Central America. Fair Trade prices were calculated as per their regulations. Specialty coffee prices are estimated according to information obtained in interviews with the Specialty Coffee Association of Costa Rica and other producer sources from Costa Rica. Specialty coffee prices are negotiated on an individual basis, and are not reported. For ICO data, see http://www.ico.org/trade_statistics.asp.

⁷⁰ Peter Guiliano (director of coffee, Counter Culture Coffee), in discussion with the author, April 2005.

harvest on the open market.⁷¹ Therefore, Fair Trade exposes the industry to free rider problems. When a farmer delivers his Fair Trade coffee beans to the cooperative for milling, they are mixed in with everyone else's beans. So any advantage in quality he might have is diminished by the quality of the rest of the coffee. Thus, Fair Trade inadvertently encourages mediocrity in production.

A simple example will help illustrate this point. A producer has two bags of coffee to sell and only one can be sold as Fair Trade. He knows bag A would be worth \$1.40 on the open market and bag B \$1.20. Which should he sell as Fair Trade? If he sells A as Fair Trade, he earns \$1.31 + \$1.20, or \$2.51. If he sells B as Fair Trade, he earns \$1.40 + \$1.31, or \$2.71. Therefore, to maximize his income, he will choose to sell his worst beans, bag B, as Fair Trade. If the farmer knows that whatever the quality of the beans in bag B, he can still sell them for \$1.31, he may increase his income by reallocating his resources to boost the quality of bag A. For example, he might stop fertilizing one group of plants and concentrate on improving the quality of the others. The result might be that bag A would sell for \$1.50 on the open market, while bag B is locked in at the \$1.31 price, even though the quality has gone down.

His gain would go from \$2.71 for his harvest to \$2.81.

So how Fair Trade may actually work in establishing economic security for these farmers is as a cheap hedge. A hedge is an investment or contract that removes or reduces risk, usually in the form of interest rate or exchange rate exposure, to the investor. Hedges are used widely in the international business community. In the case of coffee, although the market for specialty coffee is somewhat less volatile than the market for exchange-grade coffee, the primary risk to the producer is the potential for a dramatic and unforeseen price drop.⁷² By guaranteeing a minimum price, Fair Trade effectively guards against this risk in the same manner as a forward contract. Large corporations with sophisticated finance divisions hedge in a number of ways, including options and futures contracts. However, these types of hedging activities require a familiarity with international finance markets, which the average farmer does not possess.

Fair Trade also promises more than just a higher price. Fair Trade rules also provide for pre-financing for producers. Because the expense of growing coffee is spread over the entire year, but the profits are concentrated into a few months after the

⁷¹ Michael Keaton, (certification associate, Transfair USA), in discussion with the author, June 7, 2005.

⁷² Mauricio Cercone (executive director, Specialty Coffee Association of Costa Rica), in discussion with the author, June 2005.



This is the receiving station of the mill at CoopeDota, where farmers deliver their berries. The berries' quality and quantity is determined at this point.

sale of the harvest, credit plays an important role in the coffee industry. Fair Trade rules require up to 60 percent of a contract to be paid prior to delivery of the harvest. However, in Costa Rica, the law dictates that 75 percent of the contract price be paid up front to the farmer, more than what Fair Trade requires.⁷³

Does Fair Trade make a difference to the lives of the small farmer through its premiums and pre-financing? According to the FLO, the answer is an unqualified yes. "Fair Trade certification empowers farmers and farm workers to lift themselves out of poverty."⁷⁴ The FLO's web site offers producer profiles, detailing, for

example, how farmers in Huehuetenango, Guatemala, are given scholarships to send their children to school. Fedecocagua, the largest Fair Trade certified cooperative in Guatemala, says this is not the whole story. "The premium we use here [at the cooperative] . . . you saw our coffee lab, it is very professional. . . . But if I tried to give you the five cents from the Fair Trade, just for you [meaning the small farmer], probably it's nothing."⁷⁵ The representative went on to say that many organizations come to Guatemala, build a school or clinic, and then take pictures for their Web sites. In his experience, this was not a normal benefit of Fair Trade.

⁷³ This set of national laws is known as the Liquidation System in Costa Rica. In other countries, entrepreneurial microfinance companies such as Ecologic Finance step in to provide a low-cost credit market.

⁷⁴ Transfair USA, "Fair Trade Overview," <http://www.transfairusa.org/content/about/overview.php>.

⁷⁵ Gerardo Alberto de Leon (manager, Fedecocagua), in discussion with the author, November 6, 2006.

C4. IS FAIR TRADE TOO COSTLY TO BE SUCCESSFUL?

With the discussion of the benefits of Fair Trade in the press,⁷⁶ one can easily forget there are also costs associated with becoming a Fair Trade-certified organization.⁷⁷ These costs include the certification and annual inspection fees, but the larger costs exist in the organizational structure required by Fair Trade rules. “These certifications are very difficult for us because they become more and more complicated due to the fact that there are many requirements that we can’t meet,” explains cooperative member Jesus Gonzales.⁷⁸

Fair Trade rules stipulate that only cooperatives that have democratic procedures and transparency of records are eligible for Fair Trade certification. In Costa Rica and Guatemala, the coffee industry is divided into three organizational categories: cooperative, multinational, and “other.” Large, private farms and smaller farms with their own mills, for example, would fall into this third category. The Costa Rican coffee industry today is approximately 40 percent cooperative, 40 percent

multinational, and 20 percent other.⁷⁹ Of the 135 cooperatives, approximately 7.5 percent are Fair Trade certified, producing less than three percent of the country’s coffee (only 50 percent of which is sold at the Fair Trade price).

In addition to the costs of converting operations into a cooperative structure, the coffee farm faces additional challenges that are difficult to avoid because of the incentives in a cooperative work structure. For example, since cooperatives fill leadership positions by popular vote, members may select candidates for reasons other than business qualifications. Once having attained their positions, the leaders may refrain from making unpopular, but fiscally sound, business decisions in order to retain their elected positions.

However, if farmers become displeased with the management structure of the cooperative, there is no need to leave the Fair Trade arrangement. Participation in a Fair Trade cooperative is completely voluntary, and farmers are free to sell their harvest to other buyers if other buyers exist.

⁷⁶ Some recent articles include, but are not limited to, “Voting with Your Trolley,” *The Economist*, December 7, 2006; “Trading on Fairness,” *The Financial Times*, September 12, 2006; Hal Weitzman, “Ethical Coffee Workers Paid Below Legal Minimum,” *The Financial Times*, September 9, 2006; Alvaro Ramazzini and Angelina Snodgrass Godoy, “A Fair Trade Port in the Storm,” *Seattle Times*, November 9, 2005; Daniel Terdiman, “Everything is Green at This Fair,” *Wired*, November 8, 2004.

⁷⁷ Unlike prior government initiatives, Fair Trade is a voluntary program whose costs are borne exclusively by those—both buyers and sellers—who chose to participate.

⁷⁸ Jesus Gonzales (Tajumuco Cooperative, Guatemala), interviewed as part of a publication of Fedecocagua, “Un Mundo de Certificacion,” produced for the 2005 Specialty Coffee Association of America meetings in Seattle, Washington.

⁷⁹ Carlos Alfaro (Director, F. J. Orlich and Brothers, Costa Rica), in discussion with the author, June 2005.

THE COSTS OF SWITCHING TO FAIR TRADE

Changing the structure of a farm to fit the strict Fair Trade cooperative business structure can impose significant costs.

- Processes for determining the distribution of the proceeds from Fair Trade need to be discussed, documented, voted on, and implemented.
- Leadership roles must be assigned subject to democratic vote if they are not already allocated in this manner.
- Sufficient information for decentralized decision-making must be available as all members are charged with making crucial determinations regarding the operation and leadership of the cooperative.
- Processes for the publication and distribution of this information must be discussed, documented, voted on, and implemented.
- Accounting systems, if not already transparent to the membership, need to be altered.
- Record-keeping systems need to be established to ensure that the proper documentation of the activities required for certification are maintained and made available to the membership.

“They want a record to be kept of every daily activity. With dates and names, products, etc. They want everything kept track of. The small producers, on the other hand, can hardly write their own name.”⁸⁰

When the choice is made to sell to an outside buyer, it is because the prices available for high-quality beans in the open market have risen due to a decrease in the supply (usually caused by some weather event). Individual buyers will offer con-

tracts for a farmer’s highest-quality beans which far surpass the Fair Trade price during these boom times in order to fulfill contract obligations. The choice to sell outside of the cooperative does not require surrendering membership, it simply means

⁸⁰ Jesus Gonzales (Tajumuco Cooperative, Guatemala), interviewed as part of a publication of Fedecocagua, “Un Mundo de Certificacion,” produced for the 2005 Specialty Coffee Association of America meetings in Seattle, Washington.

the farmer may not sell as much to the cooperative that season as usual. In some cases, such as regions where growing conditions are less than perfect, the local Fair Trade cooperative is the only buyer available because other mills are too distant. This is the case in the Zona Norte region of Costa Rica.⁸¹ In other cases, farmers remain faithful to a cooperative because the coffee is not of sufficient quality to attract another buyer or the market price for the quality of their crop is low enough that is not worth looking for another buyer.

Another hidden cost of Fair Trade is the inability of small cooperatives to enter global financial markets, especially ones allowing them to hedge their risk. As mentioned above, multinational corporations hedge risk by purchasing and selling contracts on the futures and forwards markets to protect them from the inherent industry risks. A cooperative desiring to utilize the international financial markets in this manner would require a well-qualified, financially sophisticated employee. However, small farmers, who are charged with approving the salaries of the leadership and are not normally exposed to world financial markets, would be unlikely to hire such an employee due to the high salary his qualifications would

demand. As a result, Fair Trade cooperatives do not have the same range of options available to them as non-Fair Trade cooperatives⁸² or other types of organizations.

Moreover, field research suggests that corruption may exist in many Fair Trade cooperatives in some Central American countries.⁸³ For example, the cooperative may sell beans purchased from farmers at low market prices as Fair Trade, may divert premiums to cooperative managers, or may certify larger farmers who would not normally qualify for certification.

The Fair Trade cooperative bureaucracy poses an additional concern. The cooperative structure sets up incentives for members to sometimes devote a large amount of resources to capturing Fair Trade premiums for themselves at the expense of the other farmers. One example of this might be excessive competition for the numerous management slots at a Fair Trade cooperative. Fair Trade, by virtue of the organizational structure it imposes, is characterized by more levels of bureaucracy within an organization. Fair Trade cooperatives tend to have an inefficient number of managers,⁸⁴ perhaps in part due to the demands of an increased bureau-

⁸¹ Carlos Alfaro (director, F. J. Orlich and Brothers, Costa Rica), in discussion with the author, June 2005.

⁸² A non-Fair Trade cooperative which is not subject to the same level of reporting or democratic process may be able to engage a financial expert to assist with hedging, either as an employee or as a consultant.

⁸³ Steve Brown (buyer, Quartermaine Coffee), in discussion with the author, April 2005; Eduardo Mosheim (manager, Café Britt, Costa Rica), in discussion with the author, June 2005. For more information on corruption see “The Bitter Taste of ‘Fair Trade’ Coffee,” *Financial Times*, September 8, 2006; “‘Ethical Coffee’ Workers Paid Below Legal Minimum,” *Financial Times*, September 9, 2006; and “Trading on Fairness,” *Financial Times*, September 12, 2006.

⁸⁴ Carlos Alfaro (director, F. J. Orlich and Brothers, Costa Rica), in discussion with the author, June 2005.

cracy. These layers of bureaucracy must be paid for out of the cooperative's proceeds, reducing the amount that goes to the producers.⁸⁵ In Guatemala, an executive at Fedecocagua, the largest Fair Trade cooperative, admitted that after paying for the cooperative's employees and programs, nothing of the Fair Trade premium remained to be passed on to the individual farmer.⁸⁶ As a result, CoopeDota Manager Adrian Cordero⁸⁷ believes, "It's not worth the trouble, Fair Trade."

C5. DOES FAIR TRADE REALLY HELP THE POOR?

Is Fair Trade achieving its most prominent goal: economic development? Are the Fair Trade premiums reaching those individuals at the bottom of the economic ladder? Does Fair Trade work even from the viewpoint of its promoters?

If the Fair Trade cooperative's structure is honestly embraced and its precepts followed, Fair Trade premiums pass into the control of the member farmers. These members then vote to determine how those funds are distributed. For example, they could be disbursed directly to the members in the form of cash, or used to provide some benefits to the membership, such as educational or medical services. The benefits accrue to the members who, as defined by Fair Trade rules, are small landowners.

Small landowners, however, are not the poorest segment of the coffee industry—seasonal laborers are. As in many relatively wealthier countries, immigrants flood into Costa Rica from Nicaragua, Colombia, and to a lesser extent, Panama. These individuals are too poor to own land, but supply the much-needed labor for the harvest period. While Fair Trade notes that farmers should pay seasonal labor at least the country's minimum wage, the FLO does not require the farmer to keep records of such payment, nor does it verify the wages paid during the certification or annual inspection processes. Additionally, as migrant workers are migratory by definition, they are not members of the stationary Fair Trade cooperatives and are thus not subject to inspection. The Fair Trade premiums are disbursed to the membership. Thus, even if the premiums do filter down to the target population specified by Fair Trade rules—small landowners—the poorest of the poor remain unaffected.

No matter how well-run or benevolent a non-cooperative private organization is, or how well it pays and treats its employees, it cannot obtain Fair Trade certification. "There are not many friends of Fair Trade in the Costa Rican coffee business," explains Carlos Alfaro, director of F. J.

⁸⁵ Eliecer Ureña Prado (dean of the School of Agricultural Economics, Universidad de Costa Rica), in discussion with the author, July 2005; Eduardo Mosheim (manager, Café Britt, Costa Rica), in discussion with the author, June 2005.

⁸⁶ Gerardo Alberto de Leon (manager, Fedecocagua, Guatemala), in discussion with the author, November 2006.

⁸⁷ Adrian Cordero (manager, CoopeDota), in discussion with the author, July 2005.

SOME ALTERNATIVES TO FAIR TRADE

For those consumers concerned with ensuring they do not support the mistreatment of workers or poor environmental policies, there are a number of options. Many companies have noted the interests of consumers—consumers willing to pay to promote their ideals—and seek to offer products of which those consumers will approve.

STARBUCKS C.A.F.E. PRACTICE

Starbucks has risen to meet the needs of the consumer. While they offer Fair Trade coffee as one of a number of options at their stores and cafés, they have also put in place what they refer to as C.A.F.E. Practice. This program defines guidelines for their buyers, specifying what Starbucks, as a company, considers to be socially responsible business practices. As such, many producers have taken note and modified business practices in order to attract the attention of Starbucks' buyers.

ALLEGRO COFFEE

Allegro President Jeff Teter firmly believes in socially responsible corporate investment. Allegro pays well above the Fair Trade price in order to obtain the quality coffees demanded by its customers. Additionally, five percent of Allegro's profits go to charity, and 85 percent of those are spent in their growers' communities.

Orlich and Brothers. Producers are especially sensitive to the name "Fair Trade" as it implies everything else is exploitation. "To make high-quality coffee, you need to pay all the workers well," he continues.⁸⁸ Quality is dependent on the level of skill of the producer and the producer's employees. During the harvest, if a picker 'strips' all of the cherries, then a large percentage of the harvest will not be ripe because the cherries do not all ripen at the same time. A large percentage of

unripe cherries will lower the quality of the coffee, resulting in much lower sale prices. Workers must meticulously select ripe cherries from among the green to ensure high quality. Unskilled or poorly paid employees will be unable or unwilling to do the job efficiently and well; therefore, a farm whose primary consideration is high quality must pay its laborers accordingly. Unfortunately, Fair Trade provides no incentive to meet a farm's goal of high-quality

⁸⁸ Carlos Alfaro (director, F. J. Orlich and Brothers, Costa Rica), in discussion with the author, June 2005.

WHOLE PLANET FOUNDATION

Whole Planet Foundation President Philip Sansone explains:

I'd like to point out that Fair Trade farmers might receive some initial benefits for the charity program, but the following must also be considered when looking at the big picture of eliminating poverty. When a retailer participates in the Fair Trade Movement, essentially, this is the message that he communicates to his customers: "Some of our products are 'Fair Trade' and all the rest are based on the exploitation of peasants by an unjust and exploitative economic system." And that is simply untrue, deceptive, and unfair to the vast majority of producers who are working just as hard in the market economy to satisfy the requirements of their customers by producing the best product possible at the best price possible. In other words, when some retailer sells "Fair Trade" products then he is saying to his customers that the other products from developing countries that he also sells, but that aren't labeled "Fair Trade" products are, in effect, "Unfair Trade" products—products that are based on the unjust exploitation of peasants who aren't receiving the "full value" of their labor due to the exploitation of an unjust economic system. This is, of course, absurd and I for one simply refuse to participate in or support the con by buying fair trade products over an equally attractive competitive product, which probably costs less because it doesn't have to support the "fair trade tax."

coffee production, but rather encourages mediocrity in production. Short of a better institutional environment, workers would receive better pay if Fair Trade, like some other organizations, provided incentives designed to reward the production of higher-quality coffee. As Jeff Teter from Allegro Coffee puts it: "To get great quality coffee, you pay the market price. Now in our instance, it's a lot more than what the FT floor prices are. One hundred percent of what we

bought was more than \$1.41. . . . It's not the FT price; it's much higher."⁸⁹

C6. IS FAIR TRADE THE ONLY OPTION?

The FLO is not the only organization that speaks of fair business practices and sustainable agriculture. A number of other organizations operate under some variety of socially-conscious business agenda. Most of these organizations support some type of labeling initiative to communicate visibly

⁸⁹ Jeff Teter (president, Allegro Coffee), in discussion with the author, February 2007.

their agendas to the general public. Some, such as Rainforest Alliance, Shade Grown, and Bird Friendly, focus more on environmental aspects. Others, such as Utz Kapeh, focus on community initiatives such as educational programs and emergency response. Each program has a different set of requirements for those producers who wish to operate under a particular label. Likewise, the stringency of the requirements and the monitoring vary greatly, with some programs providing more flexibility than others. Depending on the level and type of regulation, some organizations will be more effective than others in achieving their goals.

In the case of coffee, the incentives Fair Trade rules provide are not necessarily compatible with quality improvement and may even run contrary to the best interests of the farmers in high-cost production areas like Costa Rica and Guatemala. In fact, some small farmers have adopted Fair Trade primarily because it provides a cheap form of hedging that would otherwise be unavailable to or too expensive for the poor. In other words, when the institutional environment does not provide the conditions for the development of complex contractual arrangements for all producers, Fair Trade can be a useful institutional surrogate. However, in the long run, the best way to provide for economic development is to encourage the

adoption of an institutional environment that favors entrepreneurial activity.⁹⁰

Because of the nature of specialty coffee cultivation, entrepreneurs who engage in the high-quality production that consumers demand need to pay high wages to attract skilled and efficient labor. By focusing on quality, coffee outlets such as Allegro, Peet's, and Starbucks are in fact encouraging development and socially conscious business practices through entrepreneurship. While this does not replace a faulty institutional environment, it goes a long way to improve the lives of small farmers by providing long-term, stable business ties between coffee producers and coffee distributors. As Jeff Teter, president of Allegro Coffee, explains, "We have growers we have ongoing relationships with. We spend money back on projects in the growers' community. . . . We're doing it because we feel it is the right thing. But it's also good business."⁹¹

D. POLICY CONSIDERATIONS

The nature of the specialty coffee business is such that the market rewards quality production, but only competent labor can produce quality, and competent labor comes at a price. The incentives line up correctly to create more wealth for farmers and for their workers only when better

⁹⁰ See Israel Kirzner and Frederic Sautet, *The Nature and Role of Entrepreneurship in Markets: Implications for Policy*, Mercatus Policy Series, Policy Primer No. 4 (Arlington, VA: The Mercatus Center at George Mason University, June 2006), http://www.mercatus.org/Publications/pubID.2492/pub_detail.asp.

⁹¹ Jeff Teter (president, Allegro Coffee) in discussion with the author, February 2007

institutions are in place. Respect for the freedom of contract can play a very large part in making sure that transactions benefit all groups involved and that long-term relationships are established.

D1. INSTITUTIONAL CONDITIONS AND LOCAL LEGISLATION

A faulty institutional environment can cause serious problems and hinder substantial economic development. Fair Trade works as an institutional surrogate that helps small farmers obtain cheap hedging. While this may be desirable in the current circumstances of the market in Costa Rica and Guatemala, changes in the institutional environment would go a long way to help small farmers be more entrepreneurial. By simply changing some of their institutions, these two countries could achieve the goals of Fair Trade advocates.

Both Costa Rica and Guatemala rank relatively low in the World Bank's "Doing Business" rankings. Out of 175 countries, Costa Rica ranks 105th and Guatemala, 118th. While both countries allow their citizens to register property without difficulty and have fairly easy access to credit, both countries exhibit very low protection for investors, high taxes on businesses, and low levels of contract enforcement. In addition, Guatemala presents an unfriendly licensing environment for its citizens; in some cases, obtaining the proper permits can take over a year.⁹² Costa Rica and

Guatemala could better serve their citizens by focusing on improving the business climate in their respective countries.

Although well-intentioned, some legislation in Costa Rica and Guatemala impedes business development rather than encourages it. For example, Costa Rica, which regulates its coffee industry far more than Guatemala, has instituted laws preventing producers from engaging in long-term contracts with buyers and exporters. The intent of the legislation is to prevent inexperienced or unknowledgeable producers from locking themselves into a low-paying contract. However, long-term contracts, widely used in other Central American countries, help to moderate the effect of business cycles on farmers by allowing them to lock in a predictable contract price. Additionally, farmers are free to negotiate a payment schedule that is most beneficial to them instead of following a law stipulating the time and amount. While there is certainly a risk of selling the harvest at an unfortunately low price, there is also the potential to lock in a very advantageous price. Either way, the price stability afforded by longer-term contracts allows for producers to better plan their business expenditures for the term of the contract, reducing the risk of unexpected volatility.

By passing this legislation, the Costa Rican government has removed a valuable tool from

⁹² World Bank, "Doing Business —Benchmarking Business Regulations," <http://www.doingbusiness.org>.

the toolkit of the small producer. Producers, recognizing this loss, admit to cultivating long-term relationships in Costa Rica, though they are not set by written contract. Due to demand for high-quality beans, buyers and exporters tend to honor these oral agreements in order to secure future supplies. Such agreements are illegal and thus not enforceable in the court system, adding another small layer of risk to the transaction.

Another example of potentially harmful legislation and the poor institutional environment is Costa Rica's Liquidation System. This legislation specifies both the timing of incremental payments and how much of the total sales price must be paid in each increment. While the laws do not specify the price, they do specify that 70 percent of the contract price is to be paid in advance. As mentioned above, Fair Trade rules impose a similar requirement. The intent of these provisions is to provide the farmer with a cash-flow stream over time that he might use to pay for needed supplies, such as fertilizer, during the off-season.

In Guatemala, which has no such legislation, financing is a regular part of the long-term contract between producer and buyer. Additionally, entrepreneurial microcredit institutions have emerged to provide financing to producers who may be unable to break into traditional credit markets. Real Guatemalan interest rates are high due to the poor standing of Guatemala in international capital markets, making domestic loans undesirable. Because of these high interest rates,

micro-lending institutions based in countries with lower rates are able to pass on these lower rates to their clientele.

Coffee-producing countries can best serve the interests of their coffee-farming communities by encouraging entrepreneurship and by limiting legislation designed to restrict the ability of a farmer/businessman to practice his craft. Even well intentioned legislation can backfire, as it has in the case of Costa Rica's prohibition against long-term contracts. Indeed, forward-looking countries will seek to remove legislative impediments, allowing market institutions to meet the needs of the farmer.

D2. THE TEMPTATION TO REGULATE FAIR TRADE

Fair Trade is a private, voluntary contractual agreement, but governments are starting to try to make this voluntary agreement law. Berkeley's Measure O ultimately failed, but the success of such a measure would most certainly do one thing: raise the retail price of coffee for the consumer. As economic theory shows, potential increases in revenue due to higher prices may be offset, at least in part, by a lower quantity of coffee sold, as consumers substitute other beverages or shop in other locales. How much the measure would do to assist the world's poor is uncertain at any rate, because of the inherent problems with Fair Trade as outlined in this paper. And finally, nothing prevents the citizens of Berkeley, or any other city, from purchasing Fair Trade coffee on their own, if they should so desire. This measure would simply reduce consumer choice.

The risk in regulating Fair Trade is that it would change the incentives for customers and producers alike. Indeed, if Fair Trade were compulsory, producers would know that they have a captive pool of customers, irrespective of the quality of the coffee. Thus, farmers would tend to produce lower-quality coffee beans for the same price. If coffee consumers could only buy Fair Trade coffee, their choice of coffee would be reduced, thereby limiting their ability to sanction the brands they don't like. Consumers always weigh different options, such as helping the poor farmers through Fair Trade and buying good quality coffee not produced under Fair Trade. Keeping the option to buy non-Fair Trade is essential to ensuring producers keep producing satisfying products.

CONCLUSION

Costa Rica and Guatemala provide an interesting look at the less than impressive impact of Fair Trade on these countries' coffee producers. Both countries offer unique settings for the Fair Trade experiment, yet also share many of the shortcomings of Fair Trade that may equally apply elsewhere. Fair Trade, by offering its certi-

fication only to small farmers, encourages small farm production. However, producers in Central America already acknowledge that the future of specialty coffee is in boutique production. The national coffee associations of both Costa Rica and Guatemala confirm that farm-specific labeling of coffee is the next innovation in the specialty coffee world. Consumers want to identify the farm where the coffee comes from, just like they wish to know from which vineyard their wine comes.⁹³ Cultivation of quality, widely acknowledged by the Central American farming community as the path to economic success, creates a need for skilled farm labor, which is then paid above minimum wage.⁹⁴

The Fair Trade experiences of Costa Rica and Guatemala leave several lessons for producers, buyers, and consumers to consider:

- A one-size-fits-all organizational structure, as imposed by Fair Trade rules, discourages competition in the global coffee market.
- The rules of Fair Trade, at least in the coffee industry, do nothing to address the situation of the industry's poorest segment.

⁹³ Carlos Alfaro (director, F. J. Orlich and Brothers, Costa Rica), in discussion with the author, June 2005; Mauricio Cercone (executive director, SCACR, Costa Rica), in discussion with the author, June and July 2005; William Hempstead (director, Anacafe, Guatemala), in discussion with the author, November 2006.

⁹⁴ Carlos Alfaro (director, F. J. Orlich and Brothers, Costa Rica), in discussion with the author, June 2005; Mauricio Cercone (executive director, SCACR, Costa Rica), in discussion with the author, June and July 2005; William Hempstead (director, Anacafe) and Gerardo Alberto de Leon (manager, Fedecocagua), in discussion with the author, November 2006.

- Fair Trade may encourage the employment of scarce resources in high-cost, low-quality growing areas that could find better uses than coffee production, thereby limiting the long-term success of the individuals it is attempting to help.
- Only a small portion, if any, of the price increase goes directly to poor farmers.
- Artificially raising the prices for coffee can lead to many unintended consequences, such as creating an incentive to increase supply, which would lead to even lower payments to farmers in the future.

Fair Trade coffee should be commended in so far as it is analogous to the efforts of voluntary private charity. However, if the desired goal is to alleviate poverty, Fair Trade is perhaps not the

best way to achieve that goal in the long run. Indeed, it is unclear whether Fair Trade eventually leads to improving the lives of those it intends to help. Some small farmers adopt Fair Trade primarily because it provides a cheap form of hedging that would otherwise be unavailable to the poor. In the context of a faulty institutional environment, Fair Trade can be a useful solution to erratic long-term prices.

In the long run, the right institutional framework can best address the main problems that Fair Trade attempts to resolve—low pay for the poorest segment of the population and erratic business cycles. An institutional context that allows trade and entrepreneurship to flourish is the best way to foster prosperity. Before promoting Fair Trade coffee, policy makers and others should heed the lessons from Costa Rica and Guatemala.

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