



microNOTE #21

Sustainable Coffee Increases Incomes

Value chain upgrading and improved transparency increase smallholder farmers' incomes in Mexico



Conservation International

Harvesting Conservation Coffee in Chiapas, Mexico

This case study¹ is about how rural poor smallholder coffee farmers in the State of Chiapas in southern Mexico achieved significant increases in their earnings as a result of sales into a higher value market channel established in cooperation between Conservation International (CI) and the Starbucks Coffee Company (Starbucks) in a project funded by the United States Agency for International Development (USAID).

¹ For the full case study, see Millard, Edward. 2005. "Sustainable Coffee: Increasing Income of Small-Scale Coffee Farmers in Mexico through Upgrading and Improved Transparency in the Value Chain." www.microLINKS.org

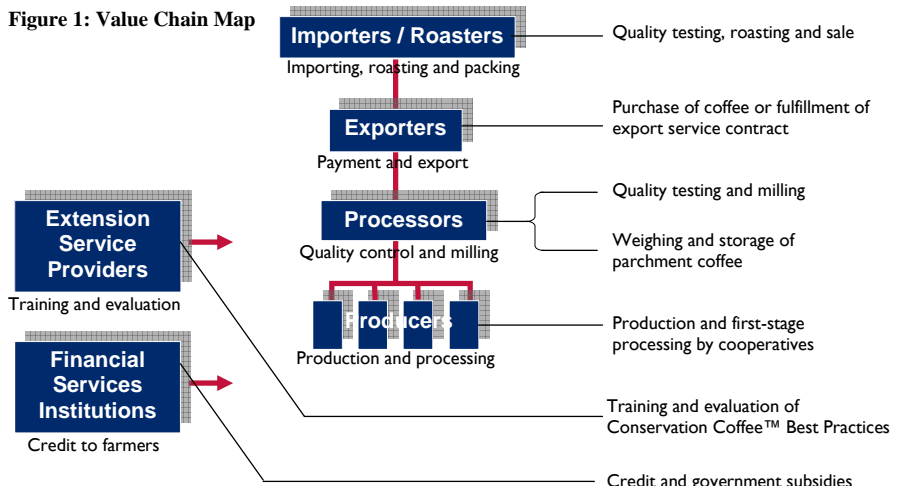
INTRODUCTION

An estimated 25 million farmers worldwide produce coffee, most of them smallholders with plots of 1-5 hectares. They operate in a global market in which supply outstrips demand, driving down prices. However, there is a growing demand for specialty coffees characterized by a high degree of product differentiation. Specialty coffee's original and still predominant characteristic is quality. Newer concepts include environmental and social benefits at the point of production, categorized together broadly as "sustainable coffees." Organically certified coffee is an important part of this segment.

THE CHIAPAS COFFEE PROJECT

The Chiapas coffee project began in 1997 when world coffee prices were at an all-time low and consequently many farmers were abandoning the crop or cutting costs. Its purpose was to define and promote a set of land management practices to conserve biodiversity in the area adjacent to El Triunfo Biosphere Reserve and to demonstrate that farmers could obtain social and economic benefits through their adoption. The CI-Starbucks partnership was designed to create a market-based incentive system to improve the environmental and social impact of coffee farming, processing and trading, resulting in

Figure 1: Value Chain Map



increased earnings for farmers, the stable long-term supply of high-quality coffee, and the conservation of biodiversity.

SMALLHOLDER COFFEE PRODUCTION

The farmers targeted by the project harvest their coffee in the form of cherries from the tree and undertake the first stage of processing to remove the beans and dry them. Farmers sell the dried beans to independent local traders or buying agents of the processing/trading companies, or to a cooperative if they are members of one. Processing/trading companies undertake milling, a second processing stage that consists of removing the skin (parchment) and then sorting and grading for quality. The processor/trader bags the green unroasted beans for export or local sale. Export-quality green coffee is imported either by a trading company that sells it on to a roaster or by a roaster directly. The roaster roasts and blends the coffee to achieve the consistency and flavor profile determined for the brand. Most brands belong to roasters, who then sell the branded consumer products to retailers.

BRANDED, ORGANIC SPECIALTY COFFEE

Traditional coffee farming threatened the Reserve because farmers cleared the forest to plant and polluted water sources with the waste created from processing. The project's recommended best practices included the use of shade trees to protect soil and water and provide habitat to wildlife and plants; and a ban on environmentally damaging practices such as hunting, dumping coffee waste in rivers and the inappropriate use of chemicals. Coffee produced according to these practices was trademarked by CI as Conservation Coffee™.

Adopting the best practices imposed costs on the farmers, including time to attend technical training and complete required documentation recording progress on annual targets, and increased labor investment in their farms. The main incentive to adopt the best practices was the availability of a market paying premium prices: Starbucks agreed to buy coffee meeting its quality requirements while fulfilling the best practices annual targets. It marketed the coffee under the brand name "Shade Grown Mexico."

MARKETING AND OTHER SUPPORT SERVICES

Starbucks initially placed contracts directly with smallholder coffee cooperatives, but these cooperatives quickly demonstrated their inability to meet the challenges of exporting. CI therefore temporarily stepped in to cover the lack of marketing capacity of the cooperatives before establishing a relationship with a broker, which Starbucks later designated as its sole supplier in order to reduce transaction costs. Although this arrangement resulted in increased returns to farmers and a greater degree of transparency in pricing, four of the cooperatives rejected the requirement to work through a broker and withdrew from the project believing that they would obtain higher prices by selling directly to buyers elsewhere.

In addition to marketing services, farmers required access to agricultural training and extension, business planning training and financial services—all of which were also initially intended to be provided through existing cooperative organizations. CI found the cooperatives to be inexperienced, administratively weak and unable to communicate to the farmers the concept of best practices or the risks and obligations associated with receiving credit and accessing international markets. As a result, CI began providing these services directly. As the cooperatives' skills and experience increased, CI transferred the implementation of these services to the coopera-

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tives and to independent service providers.

However, the failure of the cooperatives to provide effective horizontal linkages between producers continues to present two ongoing challenges: institutional sustainability and scale of impact. CI is evaluating the option of establishing a local organization to assume most of its own remaining role, including validating the best practices, facilitating cooperatives' negotiations with service providers and clients, and monitoring exports.

PROJECT IMPACT

CI commissioned a socio-economic study in 2003 that revealed the following:

- Practically all coffee producers, both beneficiaries and non-beneficiaries, implemented three recommended conservation practices: pulp separation without polluting the rivers, shade management and tree planting.
- As a result of increased harvests and price developments, the profitability of a hectare of coffee in 2003 was 6,754 pesos (U.S. \$570) for beneficiaries and 5,368 pesos (U.S. \$453) for non-beneficiaries.
- Beneficiaries in 2003 had an average yearly net income of \$36,392 pesos (U.S. \$3,071). Non-beneficiaries obtained \$20,392 pesos (U.S. \$1,721).

LESSONS LEARNED

THE ROLE OF THE LEAD FIRM

The Chiapas coffee project demonstrated the importance of creating a partnership with the lead firm very early in order to create the market incentives for changing behavior in the value chain. Farmers must perceive realistic market opportunities if they are to commit to spending time in project planning and adopting practices that cost them money and effort. Starbucks played four critical roles in the Chiapas coffee project.

- 1. Provided market demand:** Starbucks provided market demand for the finished product, paying a premium for the attributes of generating conservation benefits in the production community. This leadership also sends a challenge to other coffee companies to move in a similar direction to avoid weakening their capacity to compete for raw material supplies.
- 2. Required strengthened and transparent linkages:** Starbucks contracts state both the price that Starbucks will pay the broker and the price that the broker will pay the cooperatives, including a detailed costing of each of the processing and exporting services that the broker provides. By purchasing through a broker with these model contracts, Starbucks created the requirement to address inefficiency and lack of transparency in the value chain.
- 3. Provided services:** Starbucks provided services to the cooperatives to transfer knowledge in several areas.
 - *Coffee quality:* Starbucks expertise in coffee tasting (cupping) provided information on cup quality and coffee flavor profiles. Upgrading through improved quality control systems and processing technology enables farmers to produce a high quality, consistent product that overcomes irregularities inherent in a system depending on many small production units with differing infrastructure and production practices. Conversely, inconsistency in coffee cup characteristics discourages coffee roasters from building on the trend of developing single origin coffees that command a higher price.
 - *Export/Import:* Starbucks Coffee Trading Company's expertise in contract negotiation, transportation and customs procedures facilitated market access and enabled it to develop a transparent supply system.
 - *Product and market development:* Starbucks developed a product specifically for the project and, through its own stores and retail business partnerships overseas, promoted it in North America, Asia and Europe.

4. Promoted sustainable coffee: Starbucks promoted to the industry greater environmental and social sustainability in coffee producing countries by setting the example. Its communications through public relations, media campaigns, web page design and retail promotions of “Shade Grown Mexico” built awareness among consumers about the issues of environmental, economic and social sustainability in coffee producing regions.

IMPORTANCE OF PRICE INCENTIVES

Two studies in 2003—an independent evaluation of the project and a socio-economic impact assessment by CI—interviewed farmers and concluded that the main motivation for participation in the project was the price premium obtained from Starbucks. *“According to the socio-economic studies and what was seen in the field, the advantages of Conservation Coffee for the environment have not yet been internalized fully—price is still the main, if not sole, motive.”*²

SUSTAINABLE SUPPORTING MARKETS

The Chiapas coffee project has demonstrated that farmers living below the official poverty line will pay fees for services to upgrade in response to price incentives and that private service providers can enter the market to make impacts more sustainable.

1. Direct service delivery: Where services were essential to the project’s success, but no provider could be identified—such as was the case with financial services—CI had to take direct responsibility for providing them in order to “prime the pump.” The project made a sustained commitment to providing vital services that were unavailable while simultaneously building the market. CI set standards for service provision and ensured that independent providers had the capacity and knowledge to provide them.

Farmers will pay fees for service only after the project demonstrates the value of the services to be provided. Fees must be based on realistic cost analysis and phased in as the clients perceive their value. It is helpful to have such fees embedded in the agreement with the buyer, rather than the service providers collecting fees directly from the small farmers.

Smallholders need a range of services in order to upgrade, which may be unavailable or of poor quality. Without direct delivery of services by an implementing partner, smallholder upgrading to meet the new conservation standards would not have been possible. However, direct service provision raises significant exit challenges.

2. Importance of horizontal linkages: In remote rural locations, the lack of communications facilities and infrastructure makes transaction costs higher and service provision slower. Both factors discourage service providers from entering the market and will require the project to provide services for a longer time than would be required in other environments with better enabling conditions. In such a context, strong horizontal coordination is a priority in order to develop a demand of sufficient scale to attract service providers.

Investments in increasing the efficiency of inter-firm relationships, both among producers and between producers, buyers and service providers, generate efficiencies essential to increasing industry productivity and competitiveness.

3. Importance of vertical linkages: The existing relations with the target group in the area of implementation are a strong determinant of service providers’ ability to enter the market. Relations are unfortunately of-

² Zettelmeyer, Winfried and Alan Maddison. 2004. “Agroforestry-Based Enterprise Development as a Biodiversity Conservation Intervention in Mexico and Ghana.”

ten dominated by mistrust and the perception that poor communities cannot meet sophisticated market standards. These factors slow the process of achieving sustainable service delivery. Strengthening transparent vertical linkages is key.

PRECONDITIONS TO VALUE CHAIN INVESTMENTS

The success of the Chiapas coffee project is largely the result of an MSE upgrading process driven by a private-sector lead firm. Market leaders with the capital, skills, incentives and commitment to invest in upgrading value chains that incorporate large numbers of smallholder producers can greatly accelerate growth and productivity.

Private sector market leaders are more likely to invest in upgrading a value chain incorporating large numbers of small firms when they are able to maintain some level of exclusivity in the market channel and a share of the consequent premiums. In this case, this was achieved by establishing a unique brand.

CI has played a crucial role in facilitating the relationship between Starbucks and the broker, and between the broker and the coffee cooperatives. It established the best practices and provided services necessary for upgrading where markets were weak or missing. CI continues to validate the best practices, facilitate cooperatives' negotiations with service providers and clients, and monitor export performance. In the absence of an implementer on the ground, it is highly unlikely that such relationships could have been established or maintained.

Private sector market leader willingness to invest in upgrading particular value chains is more likely to occur in the presence of a facilitating entity able to take responsibility for strengthening the organizational capacity of participating smallholders and reducing the risk of noncompliance with established agreements.

CHANGES IN POWER AND BENEFITS

By developing a product with attributes derived from the place and method of production, the dynamics of the power relationship between the smallholder farmers and the importer/roaster were changed in favor of the farmers. As a result, the benefit flow to the farmers also increased.

Accelerated Microenterprise Advancement Project (AMAP) is a four-year contracting facility that USAID/Washington and Missions can use to acquire technical services to design, implement or evaluate microenterprise development.

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Program Manager: Olaf Kula • Tel: (202) 879-0213 • OKula@acdivoca.org