Coffee institutions and economic development in producing countries

Diego Pizano*

I wish to thank the Minister of Agriculture of Brazil, who is chairing this session, for his words. One of the most creative academics of the 20th century, the Hungarian mathematician Paul Erdös[1], used to say that the human mind was a machine for converting coffee into mathematical theorems. I would add that coffee stimulates the mind in all fields of knowledge, ranging from music and art to philosophy and economics. We need only recall Bach's famous Coffee Cantata and note the lucid way in which speakers at this Conference have presented their arguments. I am sure that in preparing their papers they drank many cups of that fascinating beverage. I shall begin by commenting on some aspects of the interesting arguments of Professors Bates and Thorp and Ambassador Sergio Amaral, following with some comments based on my own work.

There is no doubt that reducing poverty is one of the most important objectives of coffee growing countries in Asia, Africa and Latin America. It is obvious that to achieve this goal what is needed is a dynamic process of self-sustaining growth. There is a solid body of empirical evidence that countries which have substantially accelerated their economic growth have also succeeded in achieving a speedier reduction in the percentage of the population living in extreme poverty. A dynamic economy is a necessary (but not sufficient) condition for effectively tackling the problem of poverty and marginalization. For this reason, the question of the determinants of economic growth and the role of institutions in this process is extremely important. In this brief paper, I shall approach this issue with special reference to the role played by coffee institutions in the development process in producing countries.

A. Institutions and economic development

Since the publication of Adam Smith's *Wealth of Nations* more than two hundred years ago, economists have been trying to identify the major factors influencing

* *International and Economic Adviser , National Coffee Growers Federation of Colombia (FEDERACAFE). Paper presented at the World Coffee Conference, London, 19May 2001. Opinions expressed are the sole responsibility of the author.*

economic development in different countries. Why do some countries manage to achieve annual growth rates of more than 6 percent over long periods while others record slow growth or even stagnation?

There is an extensive literature on the determinants of growth and development. A number of academics and analysts have postulated factors such as technical progress and the total productivity of factors; availability of labour, energy and natural resources; economies of scale; rates of saving and investment; the physical and social (health, education) infrastructure; the solidity of the financial sector; macroeconomic stability and the formation of physical and human capital as decisive elements in the speed and nature of economic growth in various countries. But, as consistently argued by Professor Douglass North, winner of the Nobel Prize for Economics[2], these variables cannot account for the economic process as a whole and in some countries do not even account for much of what has happened. In his view, institutions, understood as the rules of the game, together with policies and regulations have played a major role in the process of allocating resources and the economic development of all countries. This argument is so important that it deserves a more detailed explanation.

For North, institutions are the rules of the game and the codes of conduct (formal and informal) devised for a particular society; they set standards of cooperation and competition and define the property rights system applicable both to the goods market and to the market for factors of production. Institutions establish the framework within which human beings interact with one another. This framework is made up of rules, regulations and ethical and legal codes that condition and limit the behaviour of the various economic agents. If institutions provide the rules of the game, organizations and managers are the actors or players. According to North, organizations are made up of groups of people who get together in order to achieve common objectives. There are political Organizations (Congress, for example), economic (unions, firms and cooperatives), educational (colleges, universities) and social (churches, clubs).

In the speech he made in Stockholm on receiving the Nobel Prize for Economics in 1993[3], North broadened these concepts by arguing that institutions define a society's incentive structure and, as a consequence, political and economic institutions are the essential determinants of economic performance. Only if transaction costs equalled zero would institutions have no importance, as demonstrated by Coase in 1959[4]. Economic and political systems that have managed to have flexible institutions and low transaction costs and have been able to survive the sudden changes taking place around them, have shown the greatest adaptive effectiveness. In North's view, the collapse of the Soviet

Union can be understood by applying a model of this type. This superpower's economic system did not permit efficient allocation of productive resources. I would add that the institutional change initiated by Mr. Deng in China has enabled that country to substantially accelerate its growth and millions of its people have been taken out of poverty during the last decade. These two examples clearly illustrate the great importance of institutions in determining the economic performance of different countries.

During his recent visit to Bogatá, Professor North told us that if a given society creates incentives for piracy, there will be lots of pirates and few sailors. If it creates incentives for bureaucrats, there will be lots of civil servants, and if it creates incentives for private sector activities, as does the United States Constitution, there will be lots of businessmen.

How can this institutional scheme be applied to the international coffee economy? The answer is clear. At international level, the most important institutions have been the International Coffee Agreement, the futures markets, the Stabex system, the Retention Agreement, the International Coffee Organization, the New York and London commodity exchanges, the European Commission and the ACPC. At national level, the institutional framework in producing countries is provided by the individual country's coffee policy and the social and legal system applicable in each country. In consuming countries there are, of course, also institutions and organizations that have influenced the behaviour of the sector. New marketing systems for specialty coffee are clearly an innovation of an institutional nature. I shall concentrate in my paper on the case of exporting countries. In organizational terms I am referring to the type of institution or marketing board responsible for carrying out the country's policies. At this point of my analysis an obvious but very important question arises: What types of institutions and organizations have proved most successful at international and national levels? This is the basic theme of the next section.

B. Coffee institutions

Before analysing the various models used by exporting countries, I would like to make some brief comments on international institutions. Firstly, it can be argued, as has been done by Professor Robert Bates[5], that the International Coffee Organization was an effective institution in terms of its effects on price stability and improved incomes in producing countries. Where I differ from this distinguished Professor is in his evaluation of the relative influence of political and economic factors. It is clear that the threat of communism in Latin America was a particularly important factor in President Kennedy's determination to support the negotiation of the Agreement in 1962. Professor Bates considers that this type of political consideration played a basic role in ensuring the support of the world's leading coffee consuming country. Without wishing to diminish the importance of this factor, I argued, a few years ago[6], that in the context of a bilateral oligopoly, it made economic sense for the participants to agree on the establishment of a price range acceptable to *both parties*. By actively participating in the design of the rules of the game for the Agreement, importing countries could defend the interests of consumers. If the Agreement had operated as a producer cartel, this would obviously not have been possible. Professor Gilbert came to the same conclusion via a different route[7]. Without its economic clauses, what role can the Agreement play? Various functions can be mentioned[8]: (a) generation of reliable data to correct problems of unbalanced information; (b) providing a forum to examine developments and prospects in the world coffee economy with the active participation of producers and consumers; (c) promoting projects in producing countries with support from the international community. Here it would be worth considering the proposal put forward by Professor Stiglitz this morning for the establishment of a tariff on coffee imports in consuming countries, the proceeds of which would be returned to producing countries in order to stabilize prices and support economic and social development projects in coffee areas; (d) promoting coffee consumption and quality improvement. Research on coffee and health should be included under this heading; (e) supporting sustainable development; and (f) promoting the creation of an international centre for scientific research on coffee along the lines of existing centres for rice, maize and other products. All these functions can be carried out with the support of the private sector in exporting and importing countries.

On the ACPC, we have had the opportunity of hearing the arguments of Ambassador Sergio Amaral. International cooperation on coffee is important. Orderly supply management can lead to greater stability of prices and supplies and could also support quality improvement, which would benefit both producers and consumers. A retention programme can relieve the situation temporarily but cannot solve problems associated with structural overproduction. Other formulas, like those proposed by Professors Bates and Gilbert, should be examined. An organization like the ACPC can also support research programmes like those being carried out by the Coffee and Health Institute at Vanderbilt University, and it has, in fact, already been doing so. It is obvious that for this type of institution to function properly, it must have the participation of all major producers and a high degree of discipline and compliance.

In relation to the Stabex system, some analysts have recognized that the Lomé Convention countries have received benefits from the transfers made but academics like Professor Roland Hermann of the University of Giessen in Germany argue that its impact has been much smaller[9].

The issue of futures markets is a complex one and I do not have the opportunity to consider it in depth. I shall limit myself, therefore, to noting that the influence of these markets in determining prices is increasing daily and that developing countries need to improve their price fluctuation management systems. As for the stabilizing or destabilizing impact of investment funds, recent studies do not allow us to reach any definite conclusions on this issue[10].

I shall now turn to management models in the coffee sector. Coffee producing countries have used various schemes, including state-run bodies, marketing boards, stabilization funds, auctions and bodies governed by agreements between public and private sectors. Experience shows that in cases where producers are marginalized in the decision-making process, coffee policy has not been the best from the viewpoint of the orderly development of the sector or the country's macroeconomic management. When the State is in complete control of this type of body, taxation levels tend to be high and a significant share of resources often ends up in other sectors. There is evidence to indicate that during boom periods various governments have not acted with long-term interests in mind; they have failed to save sufficient resources and have allowed outbreaks of the so-called Dutch disease in their economies[11].

I now wish to make a few brief comments on the Colombian coffee model, which is the one with which I am most familiar. The National Coffee Growers Federation was created in 1927 as a non-profit making organization. Its main objective was to defend producer incomes. Over the years, Colombia has developed an efficient production, exporting and marketing system which, at the same time, always seeks to reconcile coffee policies and macroeconomic considerations. The Federation has promoted scientific research, operated an extension system, carried out promotion programmes, and invested considerable resources in the physical and social infrastructure of coffee areas. How have all these activities been financed? From the outset, producers have agreed to contribute resources to finance programmes of common interest. In 1940 it was necessary to accumulate stocks in order to comply with commitments under the Inter-American Agreement on Export Quotas. The Federation and the Government decided to create the National Coffee Fund, a public treasury account administered by the Federation and built up from resources provided by the sector itself.

In the book I wrote with Roberto Junguito[12], we made a careful evaluation of the Colombian coffee model and reached the conclusion that it has strengthened the sector's competitive advantage, made it possible to improve the living conditions of coffee growers, ensured compliance with international commitments and contributed in large measure to the country's macroeconomic stability. Professors Bates and Thorp reached similar conclusions. This model has not been static, however, it has adapted itself to the changing circumstances of the international economy. At present, it is undergoing a re-engineering and restructuring process to enable it to tackle the difficult world coffee crisis referred to by the Conference Chairman.

What lessons can be offered to other coffee growing countries? There are many. In the first place, a solution must be found for the problem of collective action. Most developing countries have a very large number of farmers and it is very difficult to organize them. Voluntary contributions are not sustainable and there must be compulsory contributions to finance a strong organization. Secondly, it is indispensable to be able to count on clearly-established property rights. In countries where this condition is lacking, small producers have no access to credit and this seriously complicates the struggle against poverty. Thirdly, political interference should be kept to a minimum. The managerial and professional team in these organizations must be stable and very well-trained. Fourthly, goals and objectives must be clear and explicit and there must be proper coordination with state policies. As the veteran Colombian coffee manager, Don Arturo Gómez, used to say, to have a solid coffee policy you need a serious and flexible organization with the capacity to formulate and carry out projects.

Final reflections

Professor Robert Bates has indicated that the study of issues associated with coffee has fostered the institutional economy and promoted studies of considerable analytical value. His own work provides sufficient proof of the validity of his assertion. The document prepared by Professor Rosemary Thorp is another example of a well-structured essay bringing together elements of economic history and the new institutional economics in a particularly clear way. The work of Professor Gilbert is a valuable exercise that makes it possible to uphold the economic logic of a coffee destruction programme. I agree with much of what has been said by these distinguished academics.

To conclude I wish to say that if we want to encourage international cooperation on coffee, if we want to encourage research, sustainable development, promotion, quality improvement and risk management using futures markets, we must have solid institutions and efficient organizations in producing countries. I am not proposing state-run organizations or strong government intervention in coffee sectors. I am suggesting, on the basis of the Colombian experience, that there should be a reinforcement of flexible institutions in which the private sector plays a front-line role. Policies can be agreed with the state in and atmosphere of economic freedom, with reduced transaction costs and support for activities such as research and extension that contribute to the common good.

International experience teaches us that without an adequate institutional framework it is not possible to accelerate the development process or reduce poverty levels significantly. At international level, there is also a need for solid institutions which can help to prevent systematic financial crises, improve access to world markets for the products of developing countries and provide resources for scientific research, sustainable development and the solution of global problems. As pointed out by Professor Stiglitz at this Conference and in other writings[13], countries need to manage their entry into the international economy in a way that minimizes risks and adverse effects and maximizes benefits.

Some analysts think that the globalization process implies the demolition of the state. This is not desirable. What must be eliminated is the type of investment in which the state has no comparative advantage. In Latin America we have many examples of this type; in various countries the state has invested considerable resources in air lines, industrial enterprises and banks with very poor results. But there are some stranger examples. A few years ago, for instance, Mexico's ex-Minister of Finance, Jesús Silva Herzog, said that his country's Government had even managed a night club or cabaret and lost money on the venture. According to him, it was the only establishment of its kind that ever made a loss at world level! In the case of Argentina, an Argentine economist once told me that his country's Central Bank was running a chain of beauty salons; this is certainly a very odd activity for a Bank of this nature. It is clearly necessary to redesign the role of the state and concentrate government activities on basic areas such as education, administration of justice, regulation of markets and macroeconomic stability. On the other hand, it is very important to make good use of civil society in these processes. The private sector and well-structured non-governmental organizations can contribute a good deal to all these development issues.

[1] On this academic see Bruce Schecter's book, **My mind is open: the mathematical journeys of Paul Erdös,** Simon and Schuster, New York, 1998.

[2] North, Douglass, **Institutions, institutional change and economic performance,** Cambridge University Press, 1990.

[3] North, Douglass, **Economic performance through time,** in *American Economic Review*, June 1994.

[4] Coase, Ronald, **The problem of social cost,** in *Journal of Law and Economics*, 3:1-44, 1960.

[5] Bates, Robert, **Open economy politics: the political economy of the world coffee trade**, Princeton University Press, 1997.

[6] Junguito, Roberto and Pizano, Diego, **El Comercio exterior y la política internacional del café,** Fondo Cultural Cafetero-Fedesarrollo, Bogotá,1993.

[7] Gilbert, Christopher, Working Paper, Amsterdam, 1998.

[8] Celsius Lodder, Executive Director of the ICO, has spoken on these issues on a number of occasions.

[9] Hermann, R. **International commodity policy**, London, Routledge, 1993.

[10] See *inter alia* Gilbert, Christopher and Brunetti, Celso, **Speculation, hedging and volatility in the coffee market***,* Occasional Paper, Queen Mary and Westfield College, London, 1997.

[11] See *inter alia* Varangis, Panos *et al,* **Managing commodity booms and busts**, World Bank, Washington, 1995.

[12] Pizano, Diego, **Instituciones cafeteras y desarollo economico de Colombia,** Coffee Newsletter No. 10*,* London, Winter, 1998. See also Junguito, Roberto and Pizano, Diego, **Instituciones y instrumentos de la política cafetera en Colombia**, Fondo Cultural Cafetero-Fedesarrollo, Bogotá, 1997.

[13] Stiglitz, Joseph, **Globalization and growth in emerging countries**, Working Paper, May 8, 2001.