

## **THE FALL OF COMMUNISM AND THE RISE OF STARBUCKS: The Making of the Specialty Coffee Revolution**

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### **Expanded Abstract:**

Coffee, the world's most widely taken psychoactive drug (Pendergrast, 1999), is also the second most traded commodity in the world, petroleum being the first. 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. In the year 2000, approximately 54% of the U.S. population, or approximately 161 million people, consume at least one daily cup of coffee.<sup>1</sup> Sixteen percent of those, or about 26 million, drink specialty or gourmet coffee daily.<sup>2</sup> Indeed, once coffee has been embraced by people, they are quite loath to give it up. Even when the quality of the brewed beverage is quite poor.

For most of the 20th century, quality coffee roasting and brewing was an unrecognized art form which languished on the periphery of the American consumer's consciousness. Instead, the icon of the 5-cent cup-o'-joe took center stage. Whenever the price of coffee threatened to rise above this magical price, consumers would run screaming to their political representatives asking for emergency measures. These price fluctuations generally were not due to any illicit scheme, but rather were natural fluctuations due to the cyclical nature of the business of coffee growing.

In late 1980's, things changed. Suddenly gourmet coffee houses selling expensive coffee concoctions began to spring up everywhere. In 1988, there were 33 Starbucks coffee houses. With the exception of two (in Chicago and Vancouver), all were located in the Seattle area. Today, there are 9,671 Starbucks operating in 35 countries around the globe. Of course, while Starbucks is the market leader, several other chain and individual specialty coffee houses are also thriving, including Caribou Coffee, Peet's Coffee and Teas, and Seattle's Best, to name just a few. Have consumer preferences shifted so much? Doubtful. So why then do we have such a sudden and drastic change? And what

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<sup>1</sup> Statistics available at the Coffee Research Institute's web site: <http://www.coffeeresearch.org>

<sup>2</sup> According to the Specialty Coffee Association of America, <http://www.scaa.org/>

happened in the late 1980's that made this change possible? We believe standard public choice models shed light on this mystery.

While changes in income, the price of reasonable substitutes, etcetera may account for some of the change in consumer consumption patterns, most of the change is due to supply issues.

The U.S. entered into a cartel relationship with Latin American states in 1963 for the purpose of preventing the spread of communism among its neighbors. The slightly higher prices for coffee imposed upon the consumer in the 1960's were not welcomed, but were viewed instead as a necessary sacrifice to prevent a political disaster. The International Coffee Agreement had the effect of encouraging quantity production, as opposed to quality production. It elevated prices enough that higher cost producers could remain in a market where export quantities were stipulated by prior agreement. When the agreement collapsed in 1989, the smaller, high-cost producers found they could not survive in direct competition with Brazil, and were forced to differentiate their coffee product. The growing environment in Central America provided these countries with a comparative advantage in growing high-quality grades of coffee which could be sold at premiums, relieving them from the intense competition in the lower quality coffee commodity market.

The 1990's witnessed a tremendous change in the coffee market. While the U.S. consumer had previously been reluctant to pay more than a few cents for a cup of coffee, suddenly he was willing to pay a lot for a higher quality product, a product which did not exist in large quantities a few years before. Demand for coffee in the past had always grown relative to population and income, at a slow and steady pace. There was no explosion of population and income in the 1990's of a magnitude to explain the explosion of the specialty coffee industry. Indeed, it was the supply side changes which made the specialty coffee market possible, providing an interesting link between the fall of communism and the specialty coffee revolution.