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Do coffee roasters benefit from high prices of green coffee?

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Abstract

The German coffee industry has repeatedly made the puzzling statement that it would prefer higher prices of green coffee, its main input. Likewise, it supported the maintenance of the coffee tax. In this paper, an oligopoly model with differentiated products is used to illustrate the possibility of profit-raising cost-increases. The relationship between prices and costs of roasted coffee in Germany is estimated, and the hypothesis of overshifting is tested. In addition, the demand for coffee is studied. However, the empirical analysis does not confirm that increasing costs lead to higher profits. Alternative explanations for the coffee industry's statements, based on long term considerations, are also discussed. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

When the European internal market started in 1993, the 'small' excise taxes on tea, salt, sugar and light bulbs were abolished in Germany. The only federal excise tax that was maintained — besides the taxes on mineral oil, tobacco and alcoholic

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beverages — is the coffee tax. One reason for this exception is certainly that the coffee tax is not a nuisance tax, its revenue is more than 2 billion DM a year (whereas the total revenue of the abolished taxes was about half a billion DM). But not only the minister of finance was in favor of the coffee tax: it is a noteworthy fact that the German coffee industry explicitly supported the maintenance of the coffee tax. Likewise, the German coffee industry has repeatedly been complaining about the price of green coffee being too low. Thus the obvious question is: why do the coffee roasters want to be taxed? And why do they prefer high prices of their main input factor?

The existing literature offers two avenues for explaining why an excise tax might be in the interest of the industry. First, profit-raising cost-increases can occur in oligopolistic markets that are characterized by strategic interaction. Secondly, they may arise from Veblen effects.

In the usual case of a downward-sloping demand curve, a cost increase always lowers profits in perfectly competitive or monopolistic markets. However, profit-raising cost-increases are possible in oligopolies. For homogeneous products, this was shown by Katz and Rosen (1985), Seade (1985) and Stern (1987). Seade and Stern analyse the effect of an excise tax on prices and profits assuming constant marginal costs, and the result of cost-increases benefiting suppliers depends on the curvature of the demand curve. In contrast, Katz and Rosen explore in what way this result depends on the industry's tax and cost structures. As an example where profit-raising cost-increases have occurred, Seade points out that the operating profits (exclusive of stock revaluation) of the large multi-national oil companies underwent marked increases in the wake of the oil price shock in 1973/74.

Veblen effects arise from conspicuous consumption of luxury goods: a high price of a prestige good signals high wealth, thereby adding to the utility of the consumer. The willingness to pay increases with the price, which may lead to an upward-sloping demand curve (Leibenstein, 1950). In this case, an excise tax enlarges the market of the prestige good, which increases profits (Corneo and Jeanne, 1997)[1].

However, neither of these explanations applies directly to the German coffee market. The above-mentioned oligopoly models do not capture the characteristics of the market, because coffee is not a homogenous product. Roasted coffee is differentiated in two ways: by actual differences in flavor and by intensive

[1] It is also possible that a tax on a prestige good lowers profits, as Veblen effects do not necessarily result in an upward-sloping demand curve. Recently, Ireland (1994) and Bagwell and Bernheim (1996) analysed signalling models of conspicuous consumption. Ireland finds that the tax reduces wasteful consumption of the status good. In the model of Bagwell and Bernheim, luxury brands are sold at the consumers' preferred price, which is tax inclusive and does not vary with the tax rate. In neither case, the tax would be in the interest of the industry.

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