The Economics of Fair Trade: a guide in plain English

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The Economics of Fair Trade: a guide in plain English[1]

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"*By using fair-trade organic coffee, we help communities in Ethiopia, Peru, Indonesia, Honduras and Tanzania*"
Text from a poster in a Marks & Spencer's Café Revive

Fair Trade has grown dramatically in recent years in many developed countries and has entered mainstream markets through supermarkets, coffee retailing chains and mail order catalogues. Many of the products are guaranteed through the use of the "Fairtrade Mark" which now has a 50% consumer recognition level in the U.K.[3] As this significant consumer trend has accelerated there has been a corresponding increase in voices critical of Fair Trade. Some of these claim that, far from helping, supporters of Fair Trade are actually doing the very opposite. One influential paper[4] that focused specifically on coffee concluded: "those who … advocate various half-baked schemes to prop up prices may have the best of intentions, but they are not really helping. At best they are diverting time and energy into dead ends; at worst they could end up making the situation even worse. It may *feel* good to ignore market realities, but it won't *do* any good."

So are the sentiments underlying Marks & Spencer's poster (see above) and the actions of many consumers in purchasing Fair Trade goods simply cases of misplaced good intentions? We will argue that they are not – but in doing so we suspect that we shall surprise both proponents and opponents of Fair Trade.

Some preliminaries

First, however, we need to be clear what Fair Trade is all about. The terms "fair trade" or "fairer trade" are often used by way of contrast with "free trade". Free trade gives primacy to market forces and involves the harmonization of trading rules and the reduction of barriers to trade such as tariffs and quotas. The World Trade Organisation provides the main forum for discussions between the participating nations on such matters. In this context, fair trade is usually taken, from a developing country perspective, to mean some degree of protection in order to allow time to develop competitiveness in certain sectors until they are able to compete in world

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[1] This paper is based on an academic article: Hayes, M.G., 'On the efficiency of Fair Trade' (see www.fairtraderesearch.net), which is under review with the journal *Review of Social Economy*. The article was the focus of discussion at an International Workshop on the Economics of Fair Trade which took place in Newcastle upon Tyne in January 2005 funded by the Newcastle Fairtrade Partnership. The authors wish to acknowledge this financial support and the contributions of the participants in the development of this paper.

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[3] Fairtrade Foundation (2005), 'Awareness of the Fairtrade Mark rockets to 50%', www.fairtrade.org.uk, accessed 6 June 2005.

[4] Lindsey, B. (2004), 'Grounds for complaint', London: Adam Smith Institute.

markets. This "level playing field" argument is sometimes used in reverse, however, by industries in developed countries which seek protection from cheaper imports from competitors in developing countries. They claim that such competition is unfair because environmental or labour standards are lower than those which apply in their own country. In both cases it would be more accurate to call this "protectionism" as it seeks to protect domestic industries from international competitors.[5]

While these are clearly important issues, we do not need to get into a debate here over the merits or otherwise of such practices. This is because "Fair Trade", as we will use the term, is something quite different from such protectionist measures, negotiated as they are at national and international level.[6] Fair Trade as we will use it is to be understood as a particular type of relationship between "ethical consumers"[7] and low-income producer households through international trade. The accepted definition of Fair Trade makes this clear:

> Fair Trade is a trading partnership, based on dialogue, transparency and respect, that seeks greater equity in international trade. It contributes to sustainable development by offering better trading conditions to, and securing the rights of, marginalised producers and workers – especially in the South. Fair Trade organisations (backed by consumers) are engaged actively in supporting producers, awareness raising and in campaigning for changes in the rules and practice of conventional international trade.[8]

The question that arises, then, is whether ethical consumers in developed countries do actually enable "greater equity in international trade" or, in short, "help". In order to answer that question we need to understand the mechanisms by which Fair Trade works – or, in other words, the economics of Fair Trade.

The usual approach is to start from the consumer perspective in terms of the price premium that is often associated with Fair Trade. This involves an assumption, however, that the premium somehow filters down through the rather complex supply chain involving the retailer, the Fair Trade buying organisation (such as Traidcraft or Cafédirect), various "middle-men" involved in packaging, processing and transportation, through the local Fair Trade organisation in the developing country and eventually to the individual artisan or producer who made or grew the original product. Even stating it in these terms may already make it clear that any connection

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[5] See, for example, Bhagwati, J. (1995), 'Trade liberalisation and 'Fair Trade' demands: addressing the environmental and labour standards issues', *World Economy*, Vol. 18, No. 6, pp.745-759; Howse, R. & M. Trebilcock (1996), 'The Fair Trade – Free Trade debate: trade, labour and the environment', *International Review of Law and Economics*, Vol.16, pp.61-79; Mendoza, R. & C. Bahadur (2001), 'Toward free and fair trade, a global public good perspective', *Challenge*, Vol.45, No.5, pp.21-62; Maseland, R. & A. de Vaal (2002), 'How fair is fair trade?', *De Economist*, Vol.150, pp.251-272.

[6] A recent paper that argues against the concept of "managed trade" fails to make the distinction between Fair Trade and protectionism, and seems to imply that they are the same thing. See Singleton, A. (2005), 'Trade Justice or Free Trade?', London: Globalization Institute.

[7] The term "ethical consumer" is used descriptively to refer to those who consciously support Fair Trade by purchase, investment, donation or activism.

[8] This is the definition produced by FINE, an informal network that involves the Fairtrade Labelling Organizations International (**F**LO), the International Federation for Alternative Trade (**I**FAT), the Network of European Shops (**N**EWS!) and the European Fair Trade Association (**E**FTA). For a general description of the Fair Trade movement see, Moore, G. (2004), 'The Fair Trade movement: parameters, issues and future research', *Journal of Business Ethics*, Vol.53, No.1-2, pp.73-86.

between 10p extra on a jar of coffee and the price the individual farmer actually receives for the green coffee beans is likely to be somewhat tenuous. By contrast, then, we begin our analysis of the economics of Fair Trade in the developing country and look at the relationship between the local Fair Trade organisation and the individual producer households with which it transacts. We will return to the question of the Fair Trade premium towards the end.

One final preliminary point is necessary. The analysis which follows is based on orthodox economic theory which gives primacy to market forces and assumes rational optimisation by competitive individuals. This is *not* to argue that such analysis captures the full reality of Fair Trade but, since the arguments against Fair Trade are based within such orthodox economic theory, if it can be shown that the claims against Fair Trade can be countered *on their own terms*, they then fall to the ground independently of the degree of realism.[9]

Producer households, conventional employers and local Fair Trade organisations

The economic situation of producer households in developing countries

In an advanced urban industrial economy such as the U.K. unemployed people usually have no independent means of subsistence when they are out of work. They depend upon welfare benefits or their families, until such time as they might get another job. In contrast, the situation in a developing country with no system of unemployment benefits is very different. The norm here is not unemployment but under-employment on the farm, self-employment in petty trade, non-market domestic work, or some combination of these. In other words, in a rural environment where subsistence agriculture is an option, only some production may be undertaken for the market. The same may be true for developing country workers in an urban setting who might swap market work for domestic production. Craft-workers, for example, have found market work (in their case producing craft products for trade) to mesh well with their daily life patterns, suggesting that market work can be a comparatively flexible part of the total production of the household.[10]

This distinction between market and non-market work highlights an important decision that low-income self-employed farmers or artisans and their households have to make. The decision is how much of the total time available (within physiological and social limits) should be devoted to market work. The decision will be based upon the value of the alternative – of working to produce for the household's direct consumption or use compared with the value of the market wage.[11] Initially even a

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[9] We do not claim that orthodox economic theory is so abstracted from reality as to make its description and analysis of Fair Trade untenable. The account of the economics of Fair Trade given here is, we maintain, sufficiently accurate to be recognisable to those who work in the Fair Trade movement (both local Fair Trade organisations and Fair Trade buyers) as a reasonable representation of reality.

[10] See Littrell, M. & M.Dickson (1998), 'Fair Trade performance in a competitive environment', *Clothing and Textiles Research Journal*, Vol.16, No.4, pp.176-189, particularly p.181.

[11] 'Use' includes productive investment, with a return through reducing future market purchases (e.g. darning clothes, mending pots, or even bargain hunting); enhancing to some extent the value of assets and work in progress for future sale (e.g. clearing ditches or weeding crops); and also education and training, particularly of children.

very low market wage might be sufficient to attract some of the household's labour into market work if that labour is otherwise completely idle or is engaged in domestic production of no real value even to the household. But the market wage would have to rise beyond that to convince the household to withdraw labour from increasingly productive alternative activities.[12] Eventually it may pay the rural household to give up subsistence farming altogether and derive its income solely from cash crops or wage labour. The shantytown household, by contrast, is likely to derive its income from a number of production and trading activities so that a rise in output from any one activity requires the displacement of another activity – ideally, of course, the least profitable one.

In an ideal economy[13], in which there is competition between employers for labour and sufficient demand for everyone to be employed in market work for as many hours as suits them, the market wage would rise to what we can call the "competitive rate", and would reflect the value that workers would place on their spare time.[14] However, as we have described above, the situation in developing countries (and arguably, elsewhere, but that is not our present concern) is not ideal. In developing countries workers are prepared to enter the market as soon as the market wage exceeds the least productive of their various activities – say, weeding crops - and the value of spare time does not usually enter the equation. In addition, market demand for products may well be limited, so that the total employment available in the market is less than workers are prepared to offer. In other words, households may be willing to supply labour to the market rather than weed crops, but there may be insufficient demand from the market to employ these workers fully. In such a situation, where there is a level of involuntary unemployment[15] in the market due to limited demand and this is combined with a lack of competition between employers for labour, competition between the workers themselves tends to drive wages down to the level of income achievable by those who are self-employed in 'inferior' production activities.[16]

Conventional firms and traditional remedies

In circumstances such as these how will conventional profit-maximising firms operate? They are clearly in a stronger bargaining position than workers and in some circumstances they may be able to exploit this position to make separate deals with each worker or producer. An example would be where a firm's representative travels around buying small quantities of goods such as cocoa or coffee beans from each remote individual farmer. The representative will be in a position to pay each farmer a

[12] In the terminology of economics this implies a positively sloped labour supply curve.
[13] An 'ideal economy' is, in the terminology of economics, in a state of perfect competition and full employment.
[14] In the terminology of economics the market wage at this point equals the marginal utility of leisure as a pure consumption activity which itself equals the marginal revenue product of labour.
[15] In the terminology of economics this is strictly known as aggregate involuntary unemployment – a situation in which labour is unemployed even though the market wage exceeds the marginal utility of leisure. The concept of aggregate involuntary unemployment was introduced by Keynes in his *General Theory* (1936).
[16] In an ideal economy, market wages reflect the best use to which labour of any given type can be put in the economy as a whole. In a state of involuntary unemployment, the under-employed household is at least partly restricted to what it can produce with its own equipment and resources. The household in isolation is less productive than as part of an economy-wide division of labour, hence the term 'inferior'.

different price, the minimum that he or she will accept. For some this will be at or just above the level of non-market domestic work – a level just sufficient to persuade the farmer to substitute market for non-market work.[17]

In these circumstances it can shown that the total supply of labour to the market, and hence the total output of the firms, would be the same as those that would apply in the ideal economy. But the total earnings of all producers are clearly lower than when all labour is paid at the competitive rate that would apply in the ideal economy, and the difference is extra profit for the firms.

Often, however, all the workers are brought together in a factory under one roof or, for crop production, farmers can achieve the same effect by bringing their produce to a single collection point. Regular organised markets like these, particularly if there is local demand from other local households, make it much more difficult for even the most brazen conventional firm to pay differing wages or prices to different workers or producers. However, the firm is still in a buyer's market[18] and will find that it can maximise its profits by cutting output, employment and wages below the competitive levels that would exist in the ideal economy. This is because the cost of tempting labour away from increasingly productive domestic work is not only the cost of the extra work, but the cost of increasing wages for all the existing work – or putting it the other way, cutting wages may mean losing some workers and output, but save money on those who remain.

This, then, is how the market works in such circumstances. It fails to produce the level of output that would apply in the ideal economy *and* it reduces wages. (To turn the criticism of Fair Trade, cited earlier, back on itself, "it may *feel* good to ignore market realities, but it won't *do* any good"!)

There are, however, traditional remedies for economic circumstances such as these, in the form of trade unions or a minimum wage. The initial effect of trade unions or minimum wages, of course, is to make it difficult for firms to cut wages. However, the secondary effect, as the union-negotiated wage or enforceable minimum wage is ratcheted up towards the competitive rate, is that *both* employment *and* the wage rate will converge on those that would apply in the ideal economy. This might, at first sight, seem counter-intuitive – the effect of increased wages is often thought to be that firms become less competitive and so reduce employment levels and output. But this would be the case only where wages were raised above the competitive rate.[19]

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[17] In the terminology of economics this is known as "employer monopsony" – a monopoly on supply rather than on demand. The particular case we describe here is "discriminating monopsony" where employers will use their dominant market position to discriminate between workers or producers. On monopsony generally see Pigou, A. (1932), *Economics of welfare*, 4th edition, London: Macmillan, pp.556-563; Robinson, J. (1933), *The economics of imperfect competition*, (2nd edition 1969), pp.292-304; Meade, J. (1982), *Stagflation Vol. 1: Wage fixing*, London: George Allen and Unwin, pp.44-57 and Manning, A. (2003), *Monopsony in motion*, Princeton and Oxford: Princeton University Press. The key assumptions are a fixed number of employers in an isolated homogenous labour market. This means that households face prohibitive costs of access to the wider markets of the economy as a whole so that they cannot move to locations with higher wages, nor can they supply product markets which require large-scale agricultural or industrial production and distribution technology.

[18] This is conventional employer monopsony rather than the above case of discriminating monopsony.

[19] This is the standard static monopsony result (see any of the previous references).

Local Fair Trade organisations

Our analysis of the typical economic situation in developing countries and of the traditional remedies that exist where firms have a dominant market position in relation to the employment of labour, now allows us to understand the role of what we have termed the local Fair Trade organisation. For Fair Trade at this local level can be understood principally as an alternative private sector remedy for independent producer households or other workers who cannot form a trade union and for whom no enforceable minimum wage exists. The workers or farmers may be organised into a Fair Trade co-operative that pays producers equally, an amount at least equal to the local market price on delivery of the product to the co-operative, with a dividend from profit in proportion to their sales to the co-operative at the end of the season. Alternatively, although many local Fair Trade organisations are not organised as co-operatives, they have the same objective of creating profitable work rather than maximising profit, whether as charities or enlightened employers. They have their own positive reasons for treating workers equally and offering better terms of employment. In both cases, and in general, the effect of the local Fair Trade organisation is *both* to increase wages *and* output towards those that would exist in an ideal economy.

Some criticisms of Fair Trade have suggested that by paying some workers on better terms than other non-Fair Trade workers in a particular area, Fair Trade distorts the market for labour and so is unfair to these other workers who are not employed by Fair Trade employers. Our analysis, on the contrary, suggests that (provided Fair Trade employers offer equal opportunities to all workers) it is not necessary for the local Fair Trade organisation to hire the existing employed workforce in order to improve their position – other employers will be obliged to offer wages at or close to those being offered by the Fair Trade organisation. The benefit, therefore, is more widely spread than just among those producer households which are employed by, or which supply, the local Fair Trade organisation.

But there is a further effect of the local Fair Trade organisation. So far, we have considered the effect on wages and demand and seen how Fair Trade can affect both in a positive direction. For the producer household, however, there is another benefit in relation to the cost of 'inputs" such as raw materials and equipment used in production for the market. Where these inputs have to be purchased in the market, the conditions of an ideal economy may very well not apply in the supply of both goods and finance either.

For example, the supply of agricultural inputs in a given area may not be competitive, so that farmers may have to pay monopoly prices for seeds and fertilizer as well as for equipment, spares and repairs. The local Fair Trade organisation can then play an important role in supply as well as demand. For example, artisans engaged in piece-work at home are typically provided with raw material by an itinerant buyer of the finished product and are either not free to sell to others, or are charged for materials at a price which makes sales to competitors uneconomic. A local Fair Trade organisation may instead provide a workshop with equipment where artisans can work together and draw from a common stock of raw materials and hence limit or eliminate such practices.

Of equal if not greater significance is the cost of finance. Farmers may obtain extended credit for agricultural inputs from the supplier or receive an advance from a buyer that gives the buyer the right to fix the sale price at harvest time preventing sale to a competitor. An artisan may be tied into a similar credit agreement or an equipment leasing agreement (e.g. for a sewing machine). Apart from such direct finance costs, the farmer or artisan may face a high indirect cost of finance (e.g. for a loan for transport or a building) in the absence of competitive financial services. Conventional business decisions such as these – whether to invest in productive activities – will then face what is known as a high "hurdle" rate. This means that the return on the investment would have to be both sufficiently high and certain to justify it in the first place. Where this is not the case, the investment will not be made even though under the conditions of an ideal economy it would have made economic sense to do so.

In this context the economic role of "micro-finance" institutions, often linked to local Fair Trade organisations, becomes apparent. Their role is to reduce the producer household's financing costs. Firstly, by providing a safe and low-cost deposit for money savings they allow producer households to build up cash reserves as insurance funds and reduce demand for 'distress' borrowing. Secondly, they provide small loans at rates that make production more economic for producer households without the collateral necessary to secure loans from formal credit institutions.[20]

Fair Trade organisations and the product market

Our analysis so far might seem to suggest that the Fair Trade buyers and ethical consumers in developed countries have little or nothing to do with the achievements of the local Fair Trade organisation in raising wages and output to levels closer to those that would exist in an ideal economy. To see the important role that these buyers and consumers do actually play, therefore, we now need to pay attention to the product market into which the local Fair Trade organisation sells.

So far, we have concentrated on the economic situation in the developing country. An implicit assumption is that the conventional employing firm sells either a different good or in a different location, neither of which can be supplied by the individual producer household. For example, the firm may be selling into the international coffee market, and this is clearly distinct from the market for green coffee beans into which producer households sell their labour. Even if a local Fair Trade organisation is able to establish itself in this situation, it may be faced with a competing local firm which refuses to buy from it either as a matter of inefficiency (it cannot afford to buy from organised labour) or as a matter of strategy (it wishes to protect its own dominant position). The only option then for the local Fair Trade organisation is to access the

[20] The role of Shared Interest is instructive here. This organisation offers credit facilities at competitive rates to Fair Trade buying organisations and then makes advances on their behalf to local Fair Trade organisations against orders placed by the Fair Trade buyers, thereby oiling the wheels of Fair Trade. By making soft credit facilities directly available to local Fair Trade organisations against the cash flow from Fair Trade buyers' orders for items of equipment etc. it reduces the cost of finance. See www.shared-interest.com.

product market itself – to begin to sell directly into the international coffee market, for example.

It is probably clear that a producer household cannot itself supply the product market directly. It may not be so clear, however, that the local Fair Trade organisation cannot easily enter the product market either. For to do so requires the local Fair Trade organisation to be able to compete with existing players in that market. But this requires capital investment in the widest sense, including stocks of raw materials, work-in-progress and finished goods, the necessary training in production, and those internal organisation and external trade connections which form an intangible network of customary and contractual arrangements with other parties often referred to as "goodwill". [21] Plant and equipment may be a comparatively small part of the initial investment required to enter a product market, though they will become more significant as the minimum efficient scale of production increases. To be able to compete in the product market the local Fair Trade organisation also needs to be able to absorb customer, supplier and management failures, equipment down-time, climatic problems and other hazards including the risk of price volatility that is particularly important in commodity markets.

It should be clear from this that there are formidable barriers facing an existing or potential local Fair Trade organisation that needs to enter the product market, and any suggestions that there are easy pickings through undercutting inefficient competitors in the product market are well wide of the mark. Nevertheless, many local Fair Trade organisations have succeeded, against the odds, in establishing themselves in product markets – notably the coffee co-operatives. Many of these have received assistance from government and non-government agencies at some point in their development, and have reached their present strength only after a long period of struggle. But it is this which provides the context within which the distinctive international dimension of Fair Trade becomes relevant – in the form of the importing organisation generally known as the Fair Trade buyer.

The partnership between Fair Trade buyers and local Fair Trade organisations bears some resemblance to the relationship between the different divisions of a trans-national firm. The Fair Trade buyer offers the local Fair Trade organisation similar benefits by not deliberately defaulting on contracts or renegotiating them on an opportunistic basis. The Fair Trade buyer also offers a greater sharing of production risks, longer-term contracts and planning horizons, and access to finance. The Fair Trade buyer does not have the trans-national firm's control over the production process, of course, but support from the Fair Trade buyer in areas such as training, design and quality assurance is common, sometimes provided by a sister development charity with access to grant funds.

Our analysis, therefore, suggests that the main benefit of the Fair Trade partnership to the producer household is in the process of investment in equipping the local Fair Trade organisation in such a way that it can enter and compete in the product market. The buyer reduces the local Fair Trade organisation's production costs through helping it to reach minimum efficient scale and overcome uneven production demand,

[21] In the terminology of economics this is an "efficient technology" which, in the strict sense, means that both a firm's short-period marginal cost and long-period average cost are no greater than the market price.

reducing risk and providing finance, creating additional income for investment and the opportunity to learn by doing. Hence, the medium-term commitment of Fair Trade buyers to local Fair Trade organisations, underpinned by the preferences of the ethical consumer in the ultimate product market, is a valuable, and sometime essential, contribution to the investment by local Fair Trade organisations and the producer households in equipping themselves in order to compete in global product markets.

This partnership with one or more buyers cannot in practice, and should not in principle, be the dominant source of demand for the local Fair Trade organisation in the long term. The local Fair Trade organisation must aim to become equipped to compete independently in the product market partly because the buyer cannot give an open-ended commitment to purchase irrespective of the demand conditions in the buyer's own markets. In that context, the importance of the mainstreaming of Fair Trade products through commercial channels, initially with the help but then independent of the Fair Trade buyers, becomes evident. The role of Fair Trade buyers, then, is to work with local Fair Trade organisations to enable them to establish themselves in the product market in the medium term *and* to be explicit as to how the trading relationship may decline and end at some point.[22]

It is worth mentioning cases where the local Fair Trade organisation is stronger than the Fair Trade buyer (e.g. CORR Bangladesh and Tearcraft / Traidcraft[23]) and where the buyer can work initially only with competitive local Fair Trade organisations in order to establish itself in the product market (e.g. Cafédirect and COOCAFE Costa Rica[24]). This reversal of dependency is at odds with the usual stereotype, but is consistent with our analysis that the benefits of Fair Trade for producer households are delivered by the local organisation. A strong local Fair Trade organisation may have an interest in the emergence of new Fair Trade buyers, but does not necessarily depend upon them.

The Fair Trade premium

Our argument so far has not assumed that the Fair Trade buyer pays the local Fair Trade organisation more than the market price[25] – the economic benefits have been shown to flow from improving competition for labour in the developing country and from medium-term access to credit and product markets allowing the local Fair Trade organisation to establish itself. Enhanced competition, including the entry of new firms in the labour market, would have a similar effect, so that Fair Trade can be seen

[22] Traidcraft has already begun to build in this notion of "exit strategies" – see Traidcraft (2002), 'Traidcraft's Strategy 2002-2005: a summary', Gateshead, p.4. Similarly, Shared Interest's Annual Review (2004) recorded that eight producers had left the Clearing House which it uses to operate its loan facilities, and stated: "It is pleasing that some of the producers we have worked with in the past no longer need our credit, or are strong enough to be able to access affordable credit in their local market as one of the goals of fair trade is to strengthen local economies" (p.2).
[23] See Adams, R. (1989), *Who profits?*, Oxford: Lion Publishing.
[24] See Cafédirect (2004), 'Offer for subscription', London.
[25] This is in contrast with the philanthropy and international trade theory models of Fair Trade – see Leclair, M. (2002), 'Fighting the tide: alternative trade organisations in the era of global free trade', *World Development*, Vol.30, No.6, pp.949-958 and Maseland, R. & A. de Vaal (2002), 'How fair is fair trade?', *De Economist*, Vol.150, pp.251-272.

as a complement and substitute for competition when it is weak. Nevertheless, the price paid by the buyer to the local organisation often does exceed the market price.

It is important that we are clear at the outset exactly what the source of this premium is. Any premium in the price paid by an ethical consumer may be co-opted in whole or in part by the retailer. If some or all of it is passed on to the Fair Trade buyer, it may either support the Fair Trade buyer (which itself needs investment in order to become efficient), and / or support the price paid to the local Fair Trade organisation for the goods. So, there *may* be a link between any premium paid by an ethical consumer and the Fair Trade premium in the price paid to the local Fair Trade organisation, but there is by no means any guarantee that this is the case.

A Fair Trade premium, then, may be part of the price that is paid by the Fair Trade buyer to the local Fair Trade organisation for the goods. In some cases the level of the premium may be specified and "ring-fenced" in the sense that its use for general business or community development is pre-determined,[26] and in such cases there are no efficiency implications because the price for the goods is still essentially the market price. Positive examples include community projects such as adult education facilities or the upgrade of a clean water supply.[27]

In other cases, however, the premium represents a price above the market price. Whether the Fair Trade premium is then efficient compared with a lump-sum donation depends upon the circumstances. It *could* be inefficient in an ideal economy, in which case workers would be drawn from existing market work into over-producing for a particular product market, reducing prices and incomes for unsubsidized suppliers to that market. However, we are not in an ideal world and the premium will instead have the effect of increasing economic efficiency. This will occur because the premium will encourage the substitution of a more for a less technically efficient production activity by substituting market work for 'inferior' domestic work (as we saw above).[28] Alternatively, producer households might take

[26] In some cases the Fairtrade Labelling Organizations International (FLO) standards include a mandatory premium above prices which are determined either by a minimum or a market-based measure. For example, the coffee premium is 5 US$-cents per pound. For bananas it is US$1.75 for a box weighing 18.14kg, this to be split US$0.75 for business support and US$1.00 for social, environmental and business development. In other cases the price and premium are not specified but a premium is still included. For example, the standard for cut flowers states, 'The price paid for Fairtrade products includes a Premium. This Fairtrade Premium is to be used for improvement of the socio-economic situation of the workers, their families and communities. Workers and management decide jointly about the use of the Premium". The premium in all these cases has no efficiency implications because it provides no incentive, in the form of increased marginal revenue, for the local Fair Trade organisation to increase output. Source: www.fairtrade.net, accessed 13 June 2005.

[27] These cases are cited in Fairtrade Foundation (2005), 'Fairtrade supports Kenyan flower workers – a response to the Guardian article of 5th March 2005', www.fairtrade.org.uk, accessed 6 June 2005.

[28] This so-called 'short-period' efficiency result remains valid even when an industry is in 'long-period' disequilibrium, i.e. a state of surplus capacity as observed during the depressed phase of the coffee cycle. The argument that in these circumstances Fair Trade encourages over-production by one group of poor farmers at the expense of another (e.g. Lindsey, 2004) neglects the fact that any premium is paid to the local Fair Trade organisation and not directly to the farmer. The farmer receives directly only the local market rate, which may indeed have increased towards the competitive rate as a result of the entry of the local Fair Trade organisation, and any surplus from the premium need not be distributed in such a form as to encourage increased production. If the farmer chooses to stay in the industry, this will be because the local market rate, however low, is better than the alternative. If the

more time off, courtesy of the ethical consumers or other source of the premium. It is evident, however, that the full employment of comfortably-off producer households does not represent the circumstances in which Fair Trade emerges, so that this particular case need not concern us – although an important exception is the release of children from work to go to school.

In some cases the local Fair Trade organisation (or the proportion of sales to Fair Trade buyers) may be too small to affect materially the labour market in the local area, in which case the premium will accrue wholly to the local Fair Trade organisation rather than to the individual producer households, and becomes equivalent to a donation to the organisation. The application by the local Fair Trade organisation of this donation may be positive (by way of investment in diversification, or collective provision of benefits such as health and education services) or negative (by way of supporting inefficiency in the local Fair Trade organisation). In these cases it is proper to question the effectiveness of Fair Trade organisations relative to donor agencies as a channel for poverty alleviation and changes in the distribution of wealth. But this has no consequences in terms of the efficient allocation of labour since the producer households continue to receive the market rate for their labour.

The Fair Trade premium, then, is rather more complex than might at first be thought and, as we said at the outset, any link between a retail premium and the price actually received by the individual farmer or artisan is likely to be somewhat tenuous.

Conclusions

The conclusions, then, that derive from our analysis of the economics of Fair Trade are as follows:

- The primary effect of large-scale Fair Trade is the reduction or elimination of conventional profit-maximising local firms' dominant position in relation to the labour market in developing countries. Fair Trade at this local level can be understood principally as an alternative private sector remedy for independent producer households or other workers who cannot form a trade union and for whom no enforceable minimum wage exists.

- The effect of local Fair Trade organisations is to raise *both* the level of employment *and* the wage rate towards those that would apply in an ideal economy. Fair Trade, therefore, is economically efficient in any plausible circumstances.

- Because other employers will be obliged to offer wages at or close to those being offered by the Fair Trade organisation, the benefit is more widely spread than just among those producer households which are employed by, or which supply, the local Fair Trade organisation. Fair Trade, therefore, does not distort the market for labour and so is not unfair to other workers who are not employed by Fair Trade employers. On the contrary, it helps these employees as well.

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farmer's production decision is governed by the market rate, it cannot be argued on economic grounds that one farmer's benefit from Fair Trade is at the expense of another.

- Fair Trade, however, should not mean paying workers more than the competitive rate for their labour that would apply in an ideal economy. Because Fair Trade tends to increase production, producer households benefit by more than just the increase in the price of labour. The increase in production represents a move towards the full employment of an ideal economy since it represents a re-allocation of labour away from, and not towards, 'inferior' productive activities. The increase in the price of labour that does occur, moreover, bears in general no direct relationship to any Fair Trade premium paid by the ethical consumer.

- Although it might seem rather disappointing to some, and certainly contrary to much of the conventional wisdom that surrounds Fair Trade, the ethical consumer and the Fair Trade premium are *not* the core of Fair Trade. But the medium-term commitment of Fair Trade buyers, underpinned by the preference of ethical consumers, is both a valuable, and on occasions essential, contribution to the investment that local Fair Trade organisations and their producer households need in order to become economically strong enough to compete in global product markets. It is in this sense that ethical consumers and retailers such as Marks & Spencer "help". In doing so, Fair Trade also encourages the expression of non-market values of solidarity at both local and global levels.

- However, the partnership between the local Fair Trade organisation and one or more buyers cannot in practice, and should not in principle, be the dominant source of demand for the local Fair Trade organisation in the long term. The local Fair Trade organisation must aim to become equipped to compete independently in the product market and Fair Trade buyers need to be explicit as to how the trading relationship may decline and end at some point.

- Properly understood, then, Fair Trade complements and strengthens the competitive market and has nothing to do with protectionism. Fair Trade is an essential complement to any free trade policy that includes a genuine concern for the welfare of the poor. Indeed, it could well be said that free trade *needs* Fair Trade.