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## Article

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## **Does the Fair Trade Concept Work? An Economic Analysis of Social Labels**

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The concept of Fair Trade is applied to the marketing of a variety of goods. In recent years it has met with a continually increasing interest of demanders. Different Fair Trade organisations are trying to accomplish an improvement of working and living conditions in developing countries by means of Fair Trade certificates and by paying a price evidently above world market standard. This trade concept is meant to permit basic social standards to be observed, especially in agricultural production. The article deals with the questions how Fair Trade works and if the social aims in focus can be achieved by this trade concept. Our main result is that even though efficiency of redistribution through the Fair Trade institutions is lower than through traditional relief organisations the Fair Trade concept provides an additional incentive to pay for better living conditions in the third world. Moreover there is a stimulus for producers to reorganize the production process in a more social manner even if this is not awarded by the fair trade company.

*Keywords:* Fair Trade, Social Certificate  
*JEL-Codes:* F10, L15, L66, Q17

### **1 Preliminary Remarks**

The increasing globalisation of world trade and its consequences have been criticized worldwide. Most evident token of this development are the annual protest actions on the occasion of the leading economies' conferences like the World Economic Forum in Davos. Another sign is the foundation of organisations like ATTAC who are calling for a change in international trade. Yet there have been recent initiatives which try to change the trade with certain goods.<sup>1</sup> The activities of different Fair Trade organisations like Trans-Fair or Max-Havelaar try to accomplish an improvement of working and living conditions for producers in developing countries by means of prices distinctly above the world market level. The efforts of these organisations are supported by the demanders and their

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1 Fair Trade initiatives especially work with coffee. Coffee was the first fairly-traded product. In recent years further products like tea, cocoa, sugar, honey, chocolate, bananas, orange juice, olive oil, rice and sport balls have been following.

consumer behaviour. It is true that at the moment the scope of fairly-traded products is still relatively narrow. But taking into account the growth rates of this product segment and the tendency towards an increasing interest on the demanders' side, one has to concede that the analysis of this trade concept gains in significance.<sup>2</sup> This paper will investigate the Fair Trade initiatives from an economic point of view and will answer the question if the social goals envisaged by these initiatives can be achieved by this trade concept. To begin with, the development of the Fair Trade concept will be illustrated. In the following, the stimulating effects on demanders in developed countries and producers in developing countries will be investigated thoroughly.

## 2 The concept of Fair Trade

### 2.1 The development of Fair Trade

The basic idea of Fair Trade goes back to the 1950s. This alternative trade concept has developed from the Western developing countries' increasing awareness of the fact that the different countries and social classes do not necessarily benefit to the same extent from growth of trade and economy. In many European countries, alternative trade organisations developed which tried to counteract the structural disproportions in trade between developed and developing countries.<sup>3</sup> Creating alternative distribution channels was an attempt to set a different trade concept against the structure of world trade which was regarded as unjust. The idea of Fair Trade can be understood as a form of ethic action since it requires the companies to observe their ethic and social responsibility concerning trade with developing countries. Fair Trade is designed to help to abolish disparities between developed and developing countries which have occurred due to the relative fall in raw material prices, particularly concerning agricultural products. The professed aim is to ensure the producers of a share of the total profit which matches the appropriate proceeds for their preliminary work. As a rule, this is done by the Fair Trade partners' agreeing upon a fair price.<sup>4</sup>

2 In the last years the international umbrella organisation, the Fair Trade Labelling Organisation (FLO) could register 20 per cent growth. In 2002, 600 traders in 17 consumer countries have earned about 300 million Euros with Fair Trade products. Cf. [www.transfair.org](http://www.transfair.org).

3 In Germany the «Aktion Dritte-Welt-Handel» was founded. It especially criticizes the West's affluent society and its continuing growth. For a detailed account of the development of the Aktion Dritte-Welt-Handel and this organisation's goals cp. OTTOWITZ (1997), p. 5.

4 Cf. KOMMISSION DER EUROPÄISCHEN GEMEINSCHAFTEN (1999), S. 4f.

## 2.2 Distribution channels of Fair Trade products

Apart from the sale of fairly-traded products via world shops which has already been established for a long time, the sale of products with a Fair Trade certificate has developed greatly in recent years. The products are labelled with special social labels and certificates. They are distributed via traditional distribution and marketing channels or via the internet. By using the conventional marketing and retailing structures producers in developing countries gain access to the developed countries' market. Fair Trade products become available to a wider range of consumers. In case of sale via third world shops the identity of the sales organisation serves as a guarantee for the products and the business practices meeting the Fair Trade principles. But if fairly-traded products are certificated and sold via conventional trade organisation, no such distinct mutual trust between consumers and the selling organisation can develop. Only the Fair Trade Label indicates that production and sale of the respective product have been following the guidelines of Fair Trade. By putting their label on a product, the different Fair Trade organisations<sup>5</sup> guarantee that the production in the country of origin has taken place under the observance of the respective social standards. The organisations do not trade but only give out the social labels and control the observance of social standards.

## 2.3 Goals of Fair Trade initiatives

The Fair Trade concept is meant to allow producers in developing countries to observe basic social standards in production. Most important element of the Fair Trade idea is to raise the producers' wages for their products to a price which to a certain extent clearly resides above world market price.<sup>6</sup> In addition to this guaranteed price, the producers receive an extra price bonus by some Fair Trade organisations if they produce in an acknowledged ecological way.<sup>7</sup> Apart from the guaranteed sales price further benefits for the producers consist in long-term supply relationships

5 There are various initiatives and social labels which indicate the observance of particular social standards during production in developing countries. Examples are the labels Rugmark (carpets), Fian (cut flowers) or Palmpool (washing agents). Cf. WEIBMANN and WIRTZ (2001), p. 19.

6 At the moment the minimum price for conventional Arabica coffee which is paid by Fairtrade amounts to \$1,26/lb (for organic coffee 1,41/lb), whereas the world market price in January 2004 was \$0,73. (If the world market price rises above the TransFair minimum price, an advance of at least 5 per cent above the world market price is paid.) The world market price for coffee is subject to great fluctuations: In 1994, the New York produce exchange recorded a price of 202 US cents/lb (1 lb = 0,4536 kg), in 2002 it was only about 45 US cents per lb. For the current coffee price cf. INTERNATIONAL COFFEE ORGANIZATION (2004).

7 Cf. WEIBMANN and WIRTZ (2001), p. 19.

and the right to be pre-financed. By means of paying a price distinctly above world market standard it is tried to provide an incentive for producers to participate in Fair Trade and by these means to achieve the diverse social aims and the aims of development politics. These aims are, e.g.: (1) to promote especially disadvantaged peasant families and support self reliance initiatives as well as concrete improvements for plantation workers and harvesters (2) to prohibit forced labour and child labour, (3) to obey internationally obtained employment protection guidelines, (4) to support a long-term development process of great sustainability, and (5) to provide help for conversion to non-polluting methods of cultivation and processing.<sup>8</sup> It has to be admitted that the producers only profit from the advantages of Fair Trade conditions if they are a member of one of the Fair Trade organisations. Fair Trade initiatives do not make use of minimum social standards, which many developing countries reject to introduce.<sup>9</sup> Minimum social standards tend to impose a ban on imports and sale on those producers who do not keep to the requirements. Instead, Fair Trade initiatives try to provide a positive incentive. As a tribute to the obedience of particular standards of production, Fair Trade organisations reward the producers with a payment above the market price. This price premium is meant to ease the conversion to more social methods of production.

### 3 Economic considerations about the Fair Trade idea

#### 3.1 Demanders' interest and relative prices

Most economic analyses act on the assumption that human being is a *homo oeconomicus*<sup>10</sup> and that an individual orients towards expected subjective utility in his behaviour. The model for maximisation of expected subjective utility under constraints declares that an individual will pick from a given set of alternative activities the one which promises the greatest utility. At first sight it seems surprising that in case of relatively homogeneous goods like coffee or bananas some consumers decide in favour of the more expensive product. Traditionally distributed products and Fair

8 See, for a detailed account of the Fair Trade criteria KUNZ (1999), WELFORD, MEATON and YOUNG (2003). Further information on [www.transfair.org](http://www.transfair.org).

9 For aspects of social minimum standards concerning trade see BUSSE und GROSSMANN (2003).

10 Economic analyses are not concerned with real individuals who show many different behaviour patterns. In fact, they are based on the hypothetical construction of *homo oeconomicus*, which is characterised by a limited number of behaviour patterns and character traits which are postulated a priori. Cf. MUMMERT (1995), p. 38.

Trade products hardly differ with respect to their functional utility. Regarding material, certificated and non-certificated products show at most very little divergence, they merely differ concerning the process of production.<sup>11</sup> Sometimes products have their origin in the same plantations and have only been distributed in a different way.<sup>12</sup>

The observable consumer behaviour can partly be explained with the help of economic theory. Rational consumers will opt for buying a relatively expensive Fair Trade product if its net utility is higher than that of a conventionally distributed product. In order to explain this behaviour it seems sensible to distinguish between a direct functional utility consisting in consumption of the respective goods and an additional utility. Both quantities can be recorded in the *homo oeconomicus*' utility function. Let us assume that the direct gross functional utility from the consumption of a product is the same with fairly-traded and conventionally distributed goods. Consuming a Fair Trade product, the consumer does not only profit from the consumption. Extra components like supporting the producer or organic farming provide a further utility to the consumer. In a study carried out by OTTOWITZ (1997) 74.8 per cent of the purchasers of fairly-traded coffee declared that their purchase pattern was determined by the wish to support the producers. 15.4 per cent named organic farming. Only for 6.5 per cent of the purchasers taste is the decisive factor for buying fairly-traded coffee. If the additional utility, which is only connected to the consumption of fairly-traded products, exceeds the utility losses caused by the supplementary charge for the Fair Trade products, a rational consumer will demand such a product. By linking the consumption of a product with benefits for social or ecological activities, one can cause a higher willingness to pay in certain groups of demanders.<sup>13</sup>

From the economic point of view, Fair Trade products are a product bundle. The acquisition of the conventional product is linked with a donation for social or ecological methods of production. Since both components can be obtained separately, this is called mixed bundling.<sup>14</sup> Consumers

11 Because producers often cannot market their entire produce according to Fair Trade conditions, the remaining amount is sold via traditional distribution channels at world market price. Cf. LIEBRICH (2003), p. 35.

12 PIEPEL (2000), p. 8.

13 This linking effect has been used in the campaigns of the Krombacher Brewery and of the football club First F.C. St. Pauli. The concept of the Krombacher initiative is to save one square meter of the Rain Forest from being destroyed by buying one crate of beer. In 2003, landlords in the St. Pauli district of the city of Hamburg raised the beer price by 50 cents in order to save the First FC St. Pauli Football Club from going bankrupt.

14 For the economic theory of product bundling cp. i. a. PYNDICK and RUBINFELD (2001), VARIAN (2003).

could also buy conventionally distributed products and express their social or ecological dedication by a donation to the respective relief organisation. In comparison with the separate demand for each of the product components, the joint purchase of both components (consumed product and donation) is connected with several advantages for the demander. On the one hand, the purchaser's social commitment is expressed by the buying process itself as well as the following consumption. On the other hand, this kind of donation does not cause additional transaction costs for the consumer (like expenses for information or transfer), as would have to be taken in case of a separate purchase of a donation to a relief organisation. The willingness to buy such a commodity bundle can be put down to the fact that the amount of donation linked with the purchase is relatively small. This is a so-called low-cost situation in which ethic behaviour becomes more likely. According to that, KIRCHGÄSSNER (1992, 1996) points out that the lower the costs for moral and ethic behaviour, the higher is the willingness to act in such a way.<sup>15</sup> In opposition to a general donation which is supposed to help many different people, the consumption of fairly-traded products is linked to a more concrete group of recipients. The willingness to help is raised by the knowledge about which group of people can be helped through the buying decision.

### 3.2 Features of goods and sources of information

For some consumers, knowing about the conditions of production of food is essential for their buying decision. But often consumers can find out about this property of production only by spending a considerable amount of money even after the consumption of the respective product. From an economic point of view, this can be called credence goods properties.<sup>16</sup> Unlike search properties (e.g. price) or experience properties (e.g. taste), credence goods properties do not even become obvious after the acquisition of the respective product, unless the consumer takes an additional expense in order to determine the credence goods properties or to have them determined.<sup>17</sup> Partly, consumers show an additional willingness to pay for various food products if it is clear to them that those are produced under socially acceptable conditions in the producing countries. But consumers who would like to take into account the production conditions in

15 About moral and ethic behaviour in low-cost situations cf. (i.a.) KIRCHGÄSSNER (1992, 1996), KIRCHGÄSSNER and POMMERHNE (1993).

16 Cf. DARBY and KARNY (1973).

17 Cf. HAUCAP and SCHMIDT (2002), p. 289.

the producing countries when they decide for a product suffer from an information deficit because the production conditions are not apparent in the product. However, suppliers usually have information about the production conditions. Between both sides of the market there is an information deficit, which can be used by the suppliers. Since demanders cannot make out the production conditions or can do so only by taking an additional expense, suppliers who do not observe social standards in production are encouraged to sell their goods at the price of a high-quality product. If demanders realise the suppliers' opportunity to use this information deficit in their favour, they may possibly abstain from buying food produced in high quality in order not to pay a high price for a product which after all does not contain the promised features, e.g. social production conditions. If the supplier does not succeed in convincing the demanders of the supplied food products' high production quality, the market segment for food produced under observation of certain social production conditions can collapse. Suppliers of goods produced in high quality do not succeed on the market although on the demanders' side there is a willingness to pay for food products produced according to certain social standards. The result is a process of negative selection, as described by AKERLOF (1970) who uses the example of the second-hand car market.

Suppliers have different opportunities to make clear the products' divergence with respect to their production conditions. As described above, distribution via particular chain stores ('third world shops') as well as social trademarks ('social labels') can be considered as signalling instruments. The choice of a particular distribution channel and a social label provides consumers with additional information, which can be taken into account by the consumers when they decide for a product.<sup>18</sup> In case of distribution via third world shops the sales organisation's reputation serves as a guarantee for the correctness of the production conditions which have been promised. Such a mechanism of reputation can work if the supplier has an interest in the demanders repeating their purchase and if establishing a long-term business relation promises higher profits than the short-term benefit from an asymmetry of information.<sup>19</sup> If social trademarks are used, the institutions giving out the certificates vouch for the observation of the (social) standards established by them.

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18 Cf. RAYNOLDS (2002), p. 415.

19 For construction of reputation cp. (i.a.) KLEIN (1985), TELSER (1980), WILLIAMSON (1975).



By the indication of production conditions and their surveillance through the relevant institutions the accumulation of useless measurements can be avoided. If demanders whose buying decision is greatly influenced by the way of production had to check the production conditions for themselves, it would cause enormous measurement costs. As emphasized by BARZEL (1982), it is not reasonable for demanders to carry out activities of inspection and measurement after a certain diversification of production quality (in this case of production conditions). If a demander takes measurements and decides against buying the respective product, the same product will presumably be checked by a second consumer. If the second consumer decides against the purchase as well, a third demander will possibly take an expense for measurement and inspection, etc. The result is an accumulation of search and measurement expenses, which can be counterbalanced if the producers or the institutions giving out the certificates indicate the production conditions in a way which is evident to the consumer.<sup>20</sup>

### 3.3 Social labels and price discrimination

By social trademarks or distribution via third world shops the different production conditions are indicated. This provides the consumer with additional information about the production of the respective item. This indication causes the demanders' different preferences and different willingness to pay to become obvious. Social labels thus allow a self-selection of demanders. Furthermore, it permits the demanders to be divided into different groups of consumers. Segmenting demanders in different groups permits a third-degree price discrimination, i.e. consumers showing different preferences and a willingness to pay different prices for the product which is relatively homogeneous with respect to functional utility.<sup>21</sup> If consumers can be divided in groups with different demand patterns, suppliers will set up their prices in such a way that the group of demanders with the more elastic demand curve pays a lower price than the group of demanders featuring a less elastic demand with regard to price. Suppliers who have a certain amount of market power can demand different prices for an almost identical product from these consumer groups. Transfer-

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20 See ERIE, ESCHÉ and SAUERLAND (1999), p 103.

21 The price of coffee with a Fair Trade label is about 0.5 to 1 Euro (per 100 gram) above the price of conventionally traded coffee. That means that the price of one packet of coffee (500 g) with a Fair Trade label is about 7.50 Euros whereas the price of a packet of traditionally traded coffee is about between 2.50 and 3.50 Euros.

ability of the products between the two markets, i.e. distribution of traditionally produced goods as Fair Trade products, is prevented by the application of different social labels. From the economic point of view, the group of consumers of fairly-traded products forms a club, which can be joined voluntarily by demanders who are willing to pay for the conversion to more social methods of production. The income generated by such a group (of consumers) can be used for achieving the aims envisaged.

### 3.4 Costs of fundraising and redistribution

As long as the willingness to pay of some consumers (those who are sensitized for social production) is high enough to cover the transaction costs for supervision and realisation of such quality labels, they can exist. Naturally, the transfer sum available for redistribution is diminished by the Fair Trade organisations' expenses for administration, inspection and marketing. If one wants to assess the ability of the Fair Trade organisations to achieve the envisaged social aims, it is interesting to ask to which extent the expenses for administration, inspection and marketing contribute to the transfer volume of the individual relief organisation. Unfortunately, there are only very few figures available for this assessment. Hence, in the following there will be only a selective comparison (with respect to this criterion) between two relief organisations.<sup>22</sup>

One of the most successful Fair Trade Labelling initiatives, the Max Havelaar Foundation in Switzerland, declares in its annual report of the year 2002 that the transfer volume generated by Fair Trade amounted to a total of 27.5 millions Swiss francs. According to the foundation's account, the proceeds are about 30 per cent higher than the proceeds which producers would have received for their products in conventional trade. At the same time the figures of the Max Havelaar Foundation's profit and loss account show that in order to acquire these additional receipts of 8.25 million Swiss francs (compared to conventional distribution) expenses amounting to 2.8 million francs were spent on staff, administration, marketing and inspection.<sup>23</sup> Therefore, the expenses for organisation and administration of the foundation amount to about 34 per cent of the generated transfer volume. Compared to that, the annual report of the year 2002 of the popular German relief organisation *Brot für die Welt* do-

22 The author would have liked to depict the relation of administration costs and redistribution volume, but there are hardly any accessible and meaningful figures in this field.

23 Cf. MAX HAVELAAR STIFTUNG (2002).

cuments that the organisation has spent 13.9 million Euros of the total subsidies amounting to 76.7 million Euros on project support, public relations work, advertising and administration. This means that resources to the amount of 62.8 million Euros were available for the concrete relief actions. Organisation and administration expenses therefore have a share of 22 per cent in the available redistribution volume of the *Brot für die Welt* Foundation.<sup>24</sup> A comparison of the results shows that, in relation to other relief activities, the contribution of staff and inspection costs to the total redistribution volume of Fair Trade initiatives is relatively high. Yet the share of administration expenses in the gross transfer volume is to a large extent determined by the type of aid.<sup>25</sup> The more specific supporting measures for particular recipient groups are, the more activities of preparation and inspection are required. A lower transfer sum can possibly bring about greater achievements than higher subsidies if specific activities of preparation and inspection are taken to ensure that the subsidies actually reach the groups of people which are in need of help. Therefore the results which have been determined cannot entirely answer the question whether the separate acquisition of a consumer item and a donation can be superior to the product bundle consisting of both components (Fair Trade concept) with regard to the best possible support of the living conditions in developing countries. The relief organisations' statements and the figures available are not sufficient for such an assessment.<sup>26</sup>

## 4 Effects of Fair Trade on the producers' side

### 4.1 The individual rational choice of a producer

Let us now turn to the individual rational choice of a producer in a developing country and investigate under which circumstances the participation in Fair Trade is sensible for a producer. Producers have to decide if they produce their goods in a traditional way and sell them at world market price or if they try to observe certain social standards of production

24 Cf. BROT FÜR DIE WELT (2002). These figures should be interpreted carefully because the annual reports of both foundations only give a rough sketch of the expenditure of the money. A classification into the distinct cost categories is only done roughly.

25 In interpreting these results, one should consider the fact that the share of administration costs in the funds available for humanitarian activities will presumably sink if the transfer volume increases because in all probability effects of scale can be realised.

26 The varying efficiency of the different redistribution mechanisms only becomes a problem if non-efficient transfer systems supersede efficient ones while the same groups of recipients are supported. If, on the other hand, new groups of donors are attracted by innovative donation concepts, the redistribution proves to be a Pareto-improvement both for the donor and for the recipient of the donation.

and distribute a part of their overall produce at the fair price which is promised by Fair Trade organisations.<sup>27</sup>

#### 4.2 Traditional production and distribution on world market terms

In order to depict the rational choice of a producer as simply as possible, let us assume that the producer's natural conditions enable him to produce a certain fixed quantity of goods  $x$  (with  $x > 0$ ). The costs per unit of quantity produced in a conventional way shall be termed  $c_w$ . The world market price per unit of quantity shall be called  $p_w$ . Under these assumptions, the profit function of traditional production and distribution at world market conditions turns out to be:

$$(1) \quad P_w = (p_w - c_w)x$$

Let us now turn to a producer's profit situation if he participates in Fair Trade.

#### 4.3 Social production and distribution under Fair Trade conditions

Let us again suppose that a producer can produce the quantity of goods  $x$ . As explained above, producers are guaranteed a fixed sales price ( $p_f$ ) above the world market price ( $p_w$ ) in case of participation in Fair Trade. Yet the observation of the social and partly ecological standards demanded by Fair Trade organisations causes some expense. In order to meet the criteria for participation in Fair Trade, the producers have to abstain from forced labour and child labour, keep to internationally obtained employment protection guidelines, and organise cultivation and methods of processing in a non-polluting way.<sup>28</sup> Following these demands of the Fair Trade organisations, let us assume that a producer who decides for the participation in Fair Trade has to take expenses to the amount of  $c_f$  for the production of one unit of quantity. These costs for production per unit of quantity are higher than with a traditional way of production because

27 A farmer cannot only decide for or against observing social standards in cultivation but also about cultivation itself. For instance, if the price for coffee at the world market decreases, the cultivation of other plants (e.g. of coca) becomes more attractive. Therefore, low coffee prices can cause an increased supply of coca. Cf. GERSTER (2001).

28 For an illustration of Fair Trade criteria see KUNZ (1999) and [www.transfair.org](http://www.transfair.org).

the social standards mentioned above have to be met. It is to be set that  $c_f > c_w > 0$ .

In reality one can observe that (peasant) producers in developing countries can distribute not the entire quantity of goods, but only a part of it, at the fair price  $p_f$ . This is due to the fact that the available transfer sum is determined by the demanders' behaviour and does not suffice to buy the entire quantity of goods produced under Fair Trade conditions at present. The different Fair Trade organisations try to buy from the peasants as much of their produce as possible but the quantity of purchased items is in the end determined by the demand for fairly-traded goods in developed countries. At the moment, producers can only manage to distribute 25 to 50 per cent of the produced quantity of most of their goods at Fair Trade conditions. The rest of the produced quantity they have to sell via conventional distribution channels at world market prices.<sup>29</sup> To put these facts into a formula, let us assume that the part of the overall quantity of production which can be distributed at  $p_f$  amounts to  $\pi$ , with  $\pi \in [0,1]$ . The producers can dispose of the remaining part of the production  $(1-\pi)$  only at the lower world market price  $p_w$ . The revenue from the distribution of the total amount therefore is a function of  $\pi$ :

$$(2) \quad R_f = (\pi p_f + (1-\pi)p_w)x$$

When social production conditions are observed, the production costs amount to  $c_f$  per unit because the Fair Trade organisations demand the entire quantity of production to be produced according to fair production conditions even if only a part of the produced goods can be distributed at Fair Trade conditions.<sup>30</sup> Taking into account these production costs, the profit function of a producer participating in Fair Trade turns out to be:

$$(3) \quad P_f = (\pi p_f + (1-\pi)p_w - c_f)x$$

As can be seen in equations (2) and (3), in case of participation in Fair Trade both the revenue and the profit of a producer depend on which part ( $\pi$ ) of the overall produced quantity he can distribute at the fair price

29 Cf. LIEBRICH (2002), p. 35.

30 The TransFair social label is only given to those producers who produce their goods in peasant cooperatives and are not involved in extensive plantation economy.

$p_f$ .<sup>31</sup> From the assumption  $p_f > p_w$  can be deduced that the higher  $\pi$  is, the higher is the producer's profit.

#### 4.4 A comparison of profit situations: traditional trade and Fair Trade

Producers in developing countries have to weigh up whether they profit from conversion of their method of production and participation in Fair Trade. Due to the increased production costs participation in Fair Trade is not always rational for a producer. As mentioned above, it is necessary for the participation in the Fair Trade concept to produce the entire quantity of goods according to the required social standards, which necessarily causes the production costs to rise. But in which case does the conversion of the method of production repay? A producer is undecided whether to join the fair or traditional trade concept if the profit from the distribution at world market price ( $P_w$ ) is equal to the profits from distribution at Fair Trade conditions ( $P_f$ ). With the help of the profit functions from (1) and (3), the case of profits in fair and in conventional trade being equal can be indicated:

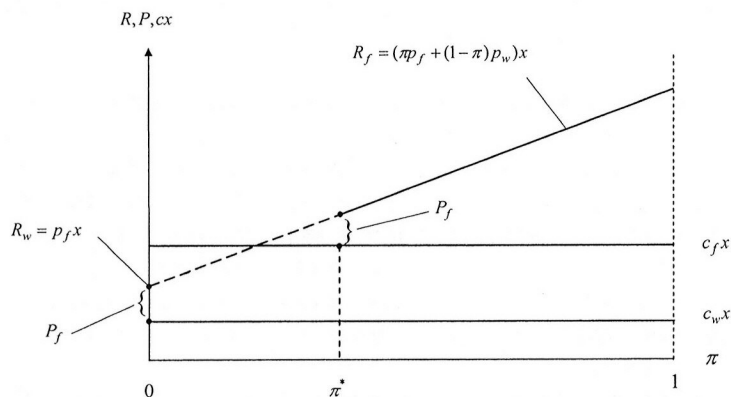
$$(4) \quad (p_w - c_w)x = (\pi p_f + (1 - \pi)p_w - c_w)x$$

$$(5) \quad \pi^* = \frac{c_f - c_w}{p_f - p_w}$$

If a producer can sell the part  $\pi^*$  of his overall production at the price  $p_f$ , the profits per unit of quantity in traditional trade correspond exactly to the profits per unit of quantity in Fair Trade. The following graphic illustrates the considerations which have been proposed:

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31 In market economies (enterprise systems) the market price has an informational, a coordinating and a sanctioning function. Prices which result from exchange processes are storage media to which the individual agents can orientate their actions. Because the Fair Trade organisations provide the producers with a long-term guarantee for the sales price, the price loses in part its function as an informational device. Yet the world market price does not entirely lose its function as a source of information. It is still available as guideline for demanders as well as producers, and producers distribute only a part of the goods produced at Fair Trade conditions.

**Figure 1** Profits in fair trade and conventional trade

If the profits of participants of Fair Trade are to exceed the profits from conventional trade, the part of the overall production which can be distributed at Fair Trade conditions must be above  $\pi^*$ . In such a situation it is reasonable for a producer to change from conventional methods of production to a more social method of production. If  $\pi < \pi^*$ , traditional production and sale at world market condition promises higher profits. As equation (5) illustrates, the part of the overall production which makes the production at Fair Trade conditions appear lucrative ( $\pi^*$ ) has to be the higher, the higher are the costs for the social standards which are required ( $c_f$ ). On the other hand, the sales quota necessary for the conversion to more social production method is the lower, the higher above the world market price is the guaranteed fair price ( $p_f$ ). If the world market prices for agricultural products fall, as has often been the case in the last decade, profits of the distribution at world market conditions fall *ceteris paribus*. This brings about a stronger incentive for producers to join the Fair Trade register.

#### 4.5 Membership and sales quotas in the Fair Trade club

The sales quota which can be distributed by an individual producer at the fair price  $p_f$  is determined on the one hand by the overall-demanded quantity of fairly-traded goods. On the other hand, it is determined by the total number of suppliers in the Fair Trade register and their quantity of production. Provided that the demanded quantity does not increase, the transfer sum set for distribution is fixed and an influx of new suppliers

must lead to a decrease of the sales quota ( $\pi$ ). The following quote shows that such a development can actually be observed in reality, especially with respect to coffee, the first Fair Trade product:

“The strong growth of Fair Trade coffee sales in Europe over the last decade is tempered by the fact that demand is still insufficient to absorb the total supply from the 550,000 small farmers on the Fair Trade Register. In fact, only about half of the total production of these groups is presently sold at Fair Trade terms, due to the limited market. Nevertheless, the producers themselves have rejected the option of closing the Register to newcomers or imposing quotas.” (RICE and MCLEAN 1999, p. 79)

But which consequences are to be expected from the admission of new producers in the Fair Trade club and how long is there a stimulus to join this club? As shown by the model considerations above, the profits from the participation in Fair Trade are only higher than the profits which can be gained in conventional trade if  $\pi > \pi^*$ . Consequently, new producers will only join the Fair Trade club as long as  $\pi > \pi^*$ . If there are already so many producers participating in the Fair Trade concept that all suppliers can only distribute the part  $\pi^*$  of their overall production at the high sales price, the influx of new producers will recede. Provided that  $\pi < \pi^*$ , producers will change from Fair Trade to conventional trade because in a situation like that the production at costs of  $c_w$  and the revenue gained by distribution at world market price promises a higher profit than participation in the Fair Trade concept. These reflections show that distribution at Fair Trade conditions is only reasonable for a producer if  $\pi \geq \pi^*$ . Otherwise, the expenditure necessary for the conversion of production by observing the social production standards causes a considerable loss of profits. A rational producer will refrain from doing so.

The graph shows that  $\pi^*$  is endogenously determined by the profit expectations in conventional trade. Therefore a fall in world prices of commonly produced agricultural products will lower the decisive share of output which is sold at the higher price of labelled products. This implies that the establishment of Fair Trade institutions causes a leverage effect on the overall share of social production standards with respect to all production activities. Not only the fairly traded amount of production, but the rest of a peasant producer's cultivated land as well becomes a place of socially acceptable production. This is a possible source of excess utility for the (well informed) consumer of Fair Trade products. The introduction of so-



cial standards for production activities which is not awarded but claimed by the Fair Trade organisations is not reflected in the redistribution efficiency statistics quoted in chapter 3.4. However, this extension of social production through the described leverage effect is probably to be considered as beneficial and desirable by the consumers of Fair trade products.

According to the considerations which were just presented, it is only lucrative for a part of all producers to participate in the Fair Trade concept whereas for other producers joining the club does not repay after a certain number of participants has been attained. A balance will set in which is marked by (i) a certain number of producers fulfilling the social standards envisaged by the Fair Trade organisations, and (ii) these producers distributing a part of their overall production to the amount of  $\pi^*$  at Fair Trade conditions. Provided that such a balanced sales quota of  $\pi^*$  can develop, the profits from Fair Trade are just sufficient to cover the additional costs which are required by the observance of the envisaged social aims.<sup>32</sup> Due to the restricted transfer sum the Fair Trade organisations have to ask themselves which social criteria shall be required for the participation in Fair Trade: The lower are the required social standards, and therefore the costs for meeting them, the more producers can be given the opportunity to keep to these social standards in production. The more extensive and cost-intensive the required social criteria are, the fewer producers will profit from these social standards and be able to produce their goods under improved working conditions.

#### 4.6 Voluntary social standards and international trade

In order to guarantee social standards in as many countries as possible, some developed countries demand the incorporation of socio-political regulations in the WTO. Yet these endeavours are rejected by numerous developing countries.<sup>33</sup> The Fair Trade initiatives based on voluntariness are interesting concepts for the accomplishment of more humane me-

32 Especially producers from Central and South America have already realised the advantages which are offered to them by the fair distribution of their products at an early time. At present, the majority of Fair Trade producers are situated in this continent whereas only a few Fair Trade producers are registered in Africa and Asia (RICE and MCLEAN 1999, p. 58). Provided that the demanded quantity of fairly-traded products does not increase, it is to be supposed that Asian and African producers will not join the Fair Trade concept because of the number of participants being already too high and the quotas ( $\pi$ ) being too low to become a member.

33 Cf. SCHNEUWLY (2003) as well as BUSSE and GROSSMANN (2003). For an overview of the arguments of the developing countries against the regulation of compulsory social standards see SLAZAR-XIRINACHS (1999).

thods of production. In opposition to social minimum standards they try to provide a positive incentive. In comparison to internationally obligatory social standards these initiatives – unlike legally determined minimum social standards for the production – have the advantage to represent the demanders' actual willingness to pay for more humane methods of production. Thus the Fair Trade initiatives draw some attention on the consumers' interest in more humane or social working and living conditions of producers in developing countries. This might provoke interesting but probably misleading questions about the moral character of trade between developing and industrial countries. The bare existence of an alternative to traditionally produced export goods of third world origin is capable to make consumers aware of their own willingness to act charitably and might be a source of compunction.

Legal minimum standards require all demanders to take higher expenses for production and inspection. With the Fair Trade concept, which is based on voluntariness, only those demanders who actually have the willingness to pay for social methods of production and express this willingness in their purchase pattern are charged to take additional expenses. Furthermore, the concept of Fair Trade does not trigger protectionist effects which can occur with the regulation of compulsory social standards.<sup>34</sup> Whereas establishing social minimum standards and introducing punishment for not obeying to them can cause a protection effect,<sup>35</sup> the Fair Trade principle is based on voluntariness and is not of an obliging nature. This is the reason why the WTO does not attack it as a protectionist trade barrier.<sup>36</sup> Producers still have the opportunity to distribute their products in a traditional way. They are not excluded from participation in international trade.

## 5 Summary

By Fair Trade initiatives consumers are given the possibility to signal their willingness to pay for a way of production of various goods which is characterized by sustainability as well as social justice. As a result, Fair Trade participants experience Pareto-improvement because both demanders

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34 For a more extensive discussion of the effects of social labels on trade see ZADEK, LINGAYAH, and FORSTATER (1998), p. 69ff.

35 The introduction of internationally binding social standards holds the danger that such minimum standards develop protectionist effects and are exploited by lobbyists. Cf. FREEMAN (1994).

36 Cf. ZADEK, LINGAYAH and FORSTATER (1998), p. 71.

and producers profit by the voluntary exchanges. Consumers of Fair Trade products are willing to pay more than the current market price in order to achieve an additional benefit. On the other hand, producers can use additional receipts for the conversion to more humane methods of production, which is in the producers' interest as well. The construction of Fair Trade itself unites two processes: fundraising and redistribution. Producers become personified, which establishes a bond between consumers and producers. This connection stimulates the tendency to help, but at the same time offers an opportunity for active support. Probably there are more efficient mechanisms of redistribution than the rather expensive Fair Trade concept. Nevertheless, the combination of fundraising and direct redistribution seems to work. The aims envisaged by the Fair Trade organisations can be achieved by the mechanism which is used. At the moment, the demand for Fair Traded products does only form a restricted part of the overall demand for products so that the transfer sum available for distribution is relatively small. This means that only a few producers can be given the opportunity to accomplish more social methods of production and a more social way of life. From the economic point of view, an extension of such Fair Trade initiatives is to be appreciated because it provides a device based on voluntariness which helps to counteract the social problems caused or revealed by international trade.

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