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**Research Report**

## The Fair Trade Balance: New Challenges after 25 years of Fair Trade

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## The Fair Trade Balance: New Challenges after 25 years of Fair Trade

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### Abstract

During the last 25 years Fair Trade (FT) experienced substantial growth, but competition from private labels is increasingly challenging the policy foundations of the FT business model. While direct welfare effects of FT for farmers are rather modest, security of delivery contracts and pre-financing arrangements appear to be of fundamental importance. Local farmer organizations and rural communities benefitted from improved service delivery.

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.../... Currently, private labels tend to outcompete FT-certification on quality performance without maintaining basic FT conditions. This proves to be a feasible upgrading strategy for more advanced FT farmers. Future pathways for FT could focus on product diversification, broadening FT towards emerging economies, or the renewal of FT as a temporary incubator strategy for providing market access to semi-commercial farmers.

### ► How Fair Trade started

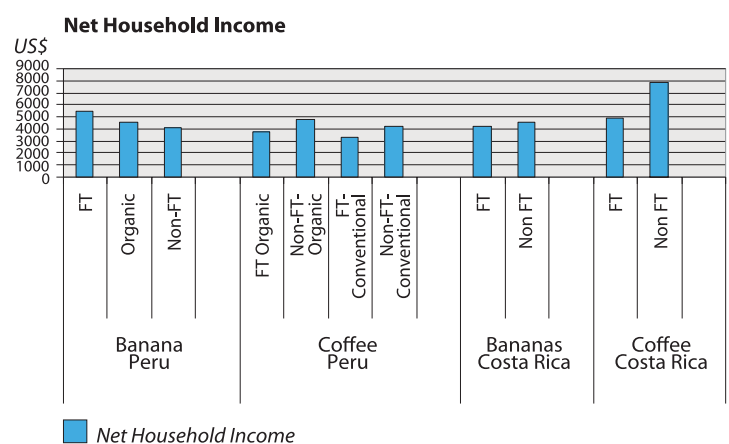
At the end of the 1960s volunteers started to launch World Shops as a protest against the failure of the UNCTAD conference to break down import tariffs on tropical commodities shipped to Western countries. Third world commodities like sugar, coffee, tea and handicrafts were directly purchased from local producer groups and sold to concerned consumers in the North. The basic foundations of the FT model were: (a) elimination of middlemen and shortening the chain between producers and consumer; (b) providing pre-finance for trade transactions before delivery takes place; (c) offering contractual arrangements regarding minimum prices; (d) payment of a premium for local community development.

The movement 'from aid to trade' was rapidly expanding and alternative trade models became professionalized, looking for mass consumer outlets with delivery through supermarkets. In major product categories like coffee, bananas and cocoa, private labels and brands launched their own certification initiatives at conditions more in line with market requirements. The proliferation of labels permits farmers to diversify outlets, but could cause also confusion amongst consumers. The FT movement is nowadays at a crossroad to decide about new pathways for developing the essential components of its future strategic orientation.

### ► Impact on farm household welfare

During the early years of FT it was sufficient to deliver life histories and testimonies of local producers regarding the perceived benefits of FT for smallholder producers. More profound impact analyses measuring the net socio-economic returns of FT for producers only started recently (Mendez, et al., 2010; Ruben, 2008; Valkila & Nygren 2009). Several studies - comparing FT and non-FT farmers - indicate that the net income effects are quite modest and most prominent for organic products, particularly when controlling for intrinsic farm size differences between farmers (see Figure 1). The price guarantee provides incentives to increase production of certified commodities, but revenues from other household activities tend to decrease due to substitution effects. However, FT producers have better access to bank credit (due to the delivery contract that serves as collateral). Moreover, FT farmers exhibit other expenditure patterns, spending more resources to education, house improvement and land upgrading. This is mainly explained by the greater income security that makes FT farmers less risk-averse.

**Figure 1:** Net FT Income Effects: coffee and bananas in Peru and Costa Rica



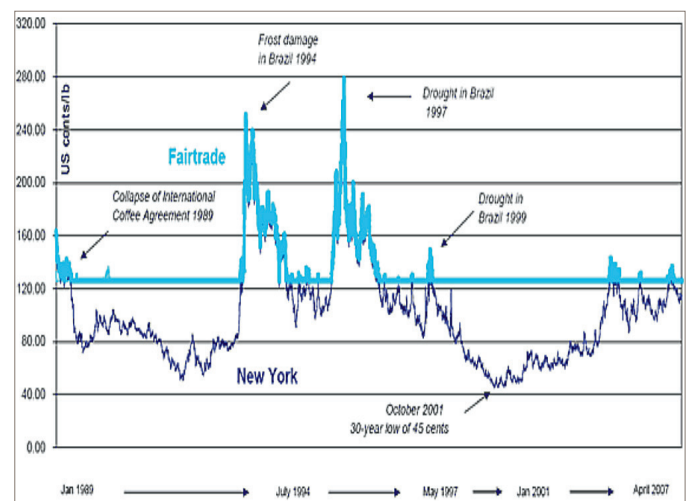
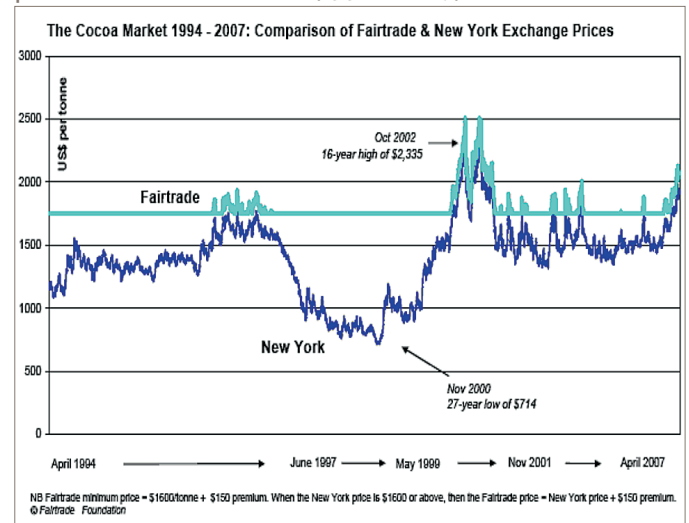
Source: Ruben (2008)

The FT contract enables them to escape from local moneylenders and the pre-finance (usually provided by development organizations and only to a small extent by processors) can be used to invest in farm upgrading.

The FT income effect depends on prices and volumes. World prices for agricultural commodities were low during the 1990s but started to rise after 2000 (see Figure 2). The FT guarantee price therefore closely resembles the ruling world price. Within the Fair Trade Labelling Organization (FLO) farmers frequently made a plea for increasing the margin, and finally the guaranteed minimum price for Arabica coffee was raised with 12% in 2011. Regarding sales volumes, the average amount of coffee sold under FT conditions rarely surpasses 25% of production. This is due to over-certification that makes supply larger than demand (with the exception of organic produce).

Whereas farmers incur substantial costs for obtaining the FT certification (initial payment of €1.500-3.000 followed by yearly tariffs of € 700-1.200) it becomes increasingly important to guarantee premium outlets. Meanwhile, market configurations for tropical commodities faced substantial changes. Former homogeneous products like coffee, tea and cocoa are nowadays marketed under advanced processing methods (pads, capsules, bags) and large investments are made for quality upgrading and taste modification. Processors increasingly select the segment of primary producers that are capable to deliver premium quality. The producers share in the market prices is gradually reduced to no more than a few percent due to high processing and packaging costs. This has profound implications for the FT market where pricing is less oriented on quality performance.

**Figure 2:** World market prices and FT guarantee prices: coffee and cocoa (1990s-2007)



## ► Cooperatives and Communities

Cooperative organization was an initial condition for FT affiliation. The FT cooperatives could better guarantee scale and realize joint investments in local processing facilities. For some products (tea, fruit, cocoa) also plantations and outgrowers were included focussing on decent labour and fair delivery conditions. The FT premium - representing 10-15% of the trade value - is usually invested in community services (drinking water, electricity, schools) that also benefit neighbouring non-FT farmers. In fact they reap a substantial share of the benefits without incurring major costs.

The same holds true for FT prices that in some regions where FT is a major market player tend to increase local commodity prices paid at the conventional market. The non-FT farmers thus receive considerable externalities derived from the FT system in terms of raising local prices and access to community-based investments.

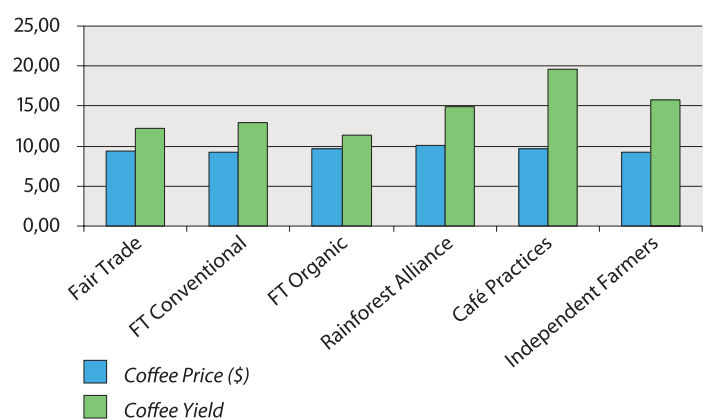
Notwithstanding the importance of cooperative production, the FT cooperatives also suffer from the usual constraints inherent to common property regimes. Cooperation also bears costs in terms of regular meetings and the willingness to share risks. Many cooperatives suffer from common internal organizational problems (e.g. free riding) that can only be partially overcome with FT support. Social service provision to member farmers has clearly improved under the FT regime, but technical assistance and internal credit still represent major constraints (Ruben & Fort, 2012). In addition, internal democracy in many cooperatives is rather limited and participation of women in decision-making hardly increased.

### ► Competition between labels

The diversification in market demand created conditions for the development of new labeling initiatives. Private brands like Starbucks, Nespresso and Lipton recently started to develop premium brands - sometimes in close cooperation with environmental NGOs - including local producers that satisfy sustainability and quality standards. Similarly, retail chains look for labels that mainstream safety and guarantee quality. For local producers this offers possibilities for engaging in multiple market outlets. Given their gained experience, FT farmers are more likely to be selected as potential suppliers to private labels. Comparative studies comparing private and FT labels (see Figure 3) suggest that the former are usually more successful in increasing yields and generating a price premium, basically because more specialized technical assistance (improved

seed; plant nutrition, etc.) is provided. In several occasions, FT farmers switched to private labels, taking advantage of the experience gained in direct trade. However, essential components of the FT approach - like pre-financing and price guarantees - are not maintained, since private labels want to be able to operate under fully free market Conditions.

**Figure 3:** FT and private labels for coffee in Northern Nicaragua



Source: Ruben & Zuniga (2011)

### ► Consumer choice

The consumer market for FT products shows great dynamics. Especially in countries where retail chains shift to full FT sourcing the market share has become substantial. Notwithstanding high annual growth rates, the overall share in the world market remains limited to 2-3% in selected commodities. Market studies indicate that the willingness to buy FT products is strongly biased towards conscious and wealthy consumers. Broader aspects of consumer choice - based on quality, taste, convenience, reputation and price - cannot always be fully satisfied by FT labels.

Even while there is still room for some further market growth, future perspectives more strongly depend on possibilities for mainstreaming FT by key industry and retail agents. In fact, both food and retail sectors

are increasingly concerned about sustainable sourcing. Given the imminent scarcity of raw materials, long-term delivery relations are considered as a fundamental condition for supply chain upgrading. This offers opportunities for new alliances with FT, as shown recently in the campaigns for mainstreaming sustainable cocoa. Based on promises for full FT labeling of the cocoa chain, substantial public resources could be raised to finance the required renewal of cocoa trees. In addition to the 'warm glow', also other production conditions (slave free, high quality) could thus be addressed.

### ► Future strategies

55 years after the start of the first World Shop and with 25 years of experience in FT labeling it is time to make an appraisal of the results and remaining challenges. Therefore, key attention should be given to the importance of the original FT principles and likely steps forward for supporting equitable trade in a changing world. It is undeniable that the broad FT network enabled more than 1.5 million producers from the developing world access to Northern consumer markets. However, the sales volume of € 3.5 billion still represents less than 2% of the world market. Annual growth rates are insufficient to guarantee producers that a major share of their certified produce can be sold under the FT label.

FT has been clearly successful in opening up the market, starting with a particular 'niche' but gradually also mainstreaming its supply to wider segments of consumers. This also marks the start of competing private labels that are able to establish and maintain more market-conform purchase conditions. It should be clearly recognized, however, that two initial conditions of the FT model are not maintained by the private labels. In the first place, they still rely on the Western regime of tariff escalation in the sense that almost all processing and

value-adding activities take place in the North. Only few locally processed brands have been successful in penetrating mainly the US market. In the second place, the FT model wanted to challenge fundamentally the organization of world trade by focusing on guaranteed prices and pre-financing systems. These conditions would challenge the reliance on future trade transactions that still generate a major source of profit to large multinational companies.

Current discussions on the future of FT are marked by a variety of viewpoints. Three main options can be distinguished. Some proponents of FT focus on *diversification* to get more product categories delivered under FT conditions. In addition to new primary commodities (gold, palm oil, soya) efforts are made for FT certification of processed products like clothing, shoes, mobile phones (FaiPhone). Others focus more on *deepening* FT searching for larger consumer segments in emerging economics (BRICS countries). In fact, in China, Brazil and the Philippines some products are already sold under FT conditions. A third option would be to position FT as an incubator strategy, focusing on the periodic renewal of segments of producers that rely on FT labels to get initial access to the market. In this view, FT only provides temporary support and explicitly aims for the transfer of more advanced producers to private labels. The latter strategy would result in a rather small but stable FT market share that is based on a periodically changing composition of farmers. This approach comes closest to the initial purpose of the FT movement and permits transparent communication with broader segments of consumers.

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