

Working Paper

‘On the efficiency of Fair Trade’

Mark Hayes

Abstract

This paper uses competitive equilibrium theory to analyse the economic efficiency of international ‘Fair Trade’ between ethical consumers and low-income producers. The main analytical innovations are the reconsideration of the labour supply decision in a state of Keynesian involuntary unemployment as a choice between work and, not leisure, but inferior production activities; and the application of Pigou and Robinson’s theory of employer monopsony, leading to a focus on the ‘local Fair Trade organisation’, which has a similar effect to a labour union or minimum wage in eliminating monopsony rents. A price premium is found neither necessary nor sufficient for Fair Trade, and in a state of involuntary unemployment a premium does not lead to inefficient allocation. The conclusion is that Fair Trade improves welfare by strengthening competition for labour, and should be encouraged as a complementary element of an enlightened trade liberalisation policy.

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INTRODUCTION

There now exist a number of academic studies of the emerging phenomenon of 'Fair Trade', understood as a particular type of relationship between 'ethical consumers' and low-income producer households through international trade. Most of the papers have high empirical content, and employ a variety of methodologies to identify relevant characteristics and organise the available quantitative and qualitative data (e.g. Bird and Hughes 1997; Littrell and Dickson 1998; Raynolds 2002; Tallontire 2000; Tiffen 2002; Renard 2003; Moore 2004). Their evaluations of Fair Trade have used the analytical perspectives of a wide range of disciplines and three in particular have used orthodox economic theory, in which sense the term 'efficiency' is employed in the title of this paper, to mean either the optimal allocation of given resources or technical efficiency in production. Leclair (2002) and Maseland and de Vaal (2002) present models of Fair Trade, based on philanthropy and international trade theory respectively, in which the benefits for particular households may be accompanied by social costs by way of allocative inefficiency ('market distortion' or 'over-production'), especially the reduction of the income of other, possibly poorer, households through lower market prices. Non-academic critics of Fair Trade (e.g. Lindsey 2004) have been quick to make similar claims. Becchetti and Adriani (2002) present a rather different model based on the interaction between an incumbent monopsonistic employer and a Fair Trade entrant supported by ethical consumers, concluding that Fair Trade can in practice be expected to improve social welfare, but that the exercise of ethical consumer preferences without Fair Trade (e.g. boycotts) reduces the welfare of the poor.

The aim of this paper is to place at the centre of the discussion the 'local Fair Trade organisation' with which individual producer households transact, and which may take various forms, either a co-operative, charitable or community organisation, or an enlightened employer. The local Fair Trade organisation plays two principal economic roles, in compensating for a lack of competition for labour, and as a channel for investment in tangible and intangible assets, in addition to any wider social and political functions. The introduction of the local Fair Trade organisation into the model permits a demonstration that any 'Fair Trade premium' in the price paid by

ethical consumers is neither a necessary nor a sufficient condition of Fair Trade. This contrasts strongly with the philanthropy and trade theory models, which collapse without such a premium. Compared with the Becchetti--Adriani model, two key concepts, the heterogeneity of the reservation wage and employer monopsony, are developed in more depth and the additional distinction is drawn between the local Fair Trade organisation, which transacts with producer households, and the 'Fair Trade buyer', which buys from the local Fair Trade organisation and sells directly or indirectly to ethical consumers.

The analysis of this paper does not offer, or depend upon, a definition of 'fairness', as does Maseland and de Vaal (2002). Fair Trade is here considered (in contrast with Barratt Brown 1993) solely in terms of allocative efficiency against the theoretical Pareto-optimal competitive benchmark using the standard tools of orthodox economic theory, which takes as given the distribution of wealth, however inequitable. The paper does not therefore consider the trade-offs between allocative efficiency and distributional equity that may properly be made as a matter of public policy. However, a link between the economics of imperfect competition and Keynes's concept of involuntary unemployment, neither of which are at the core of current orthodoxy, is central to the argument. A Marshallian partial equilibrium method is used to express the argument in deliberate preference to a mathematical general equilibrium model, since most, if not all, such models, unlike Keynes, tacitly assume full employment in the absence of imperfect competition (for example Dutt 1987).

It may be objected that equilibrium methodology of any variety is irrelevant, either because the economy is never in equilibrium, or because the sociological and institutional features of the world emphasised by heterodox economics are more important in explaining behaviour than the orthodox assumption of rational optimisation by competitive individuals. The claim made here is not that orthodox analysis captures the full reality of Fair Trade, but that Fair Trade can be analysed fruitfully even within a framework which gives primacy to market forces, without prejudice to the insights of other methodological frameworks. Secondly, there is an important distinction between the Marshallian short and long periods, and it may be realistic to follow Keynes in treating employment as in short-period equilibrium (but not necessarily full) without committing to the attainability of long-period or Walrasian equilibrium. Finally, and of relevance to the policy debate, the claim that

Fair Trade means inefficient allocation is based on equilibrium theory, so that if that claim can be countered on its own terms, it falls to the ground independently of whether it is realistic.

The term 'ethical consumer' is used in this paper descriptively to refer to those who consciously support Fair Trade by purchase, investment, donation or activism, and does not imply any particular theory of consumption. In particular, this paper offers no theory of the Fair Trade premium that some ethical consumers may be willing to pay for products or services. The analysis considers the Fair Trade premium only at the level of the transaction between the local Fair Trade organisation and the Fair Trade buyer, and abstracts from the ultimate source of any premium paid.

The second section considers the role of the local Fair Trade organisation when there is imperfect competition in the markets for the labour of the household and for the supply to the household of productive inputs including finance. The standard static monopsony result is derived for a Fair Trade context, including an understanding of the labour supply decision under conditions of involuntary unemployment as a choice between market employment and inferior domestic work or petty self-employment. The local Fair Trade organisation is found to play a similar role to a trade union or minimum wage in overcoming monoposony, thus increasing household income and promoting efficient allocation simultaneously. The third section considers the relationship between the local Fair Trade organisation and the Fair Trade buyer, and the extent to which the former is dependent on the latter; and argues that the primary economic benefit of the relationship is in reducing risk and enabling the local organisation to achieve a competitive mode of production, or 'efficient technology'. The fourth section then considers the impact of a Fair Trade premium in this relationship, and concludes that a premium is only likely to lead to allocative inefficiency in circumstances of full employment where Fair Trade is unnecessary. The conclusion is that from the perspective of economic theory based on competitive supply and demand but informed by Keynes, Fair Trade improves welfare mainly by strengthening competition for the labour of households and eliminating monopsony rents, and that there are no grounds for any *a priori* claim that Fair Trade necessarily distorts competition and promotes inefficiency.

FAIR TRADE ORGANISATIONS AND THE PRODUCER HOUSEHOLD

This section argues that the primary economic role of the local Fair Trade organisation is as a remedy for imperfect competition in the markets faced by producer households. Central to the argument is employer monopsony, for which one condition is a positively sloped labour supply curve. The first sub-section argues that this supply curve should be derived from substitution against other productive activities rather than against leisure, because a state of aggregate involuntary unemployment, rather than full employment, is the norm in the circumstances of Fair Trade.

Labour supply: leisure and involuntary unemployment

The analysis of labour supply is usually presented (including Leclair 2002) in terms of a trade-off by households between work and leisure. Leisure offers intrinsic utility, and work is a means to obtain indirectly goods other than leisure. The decision to work (i.e. supply labour to the market) is thus a decision as to the form in which to consume the endowment of labour services or working time. Fair Trade, on this view, places a premium on work, encouraging the household to substitute work for leisure: however, since the household would derive the same welfare from a lump-sum donation equivalent to the income effect of the price premium, Fair Trade involves a social cost of inefficient allocation.

If the household has the capacity to produce goods, it will be indifferent between producing goods and supplying wage labour: if it has superior production possibilities, it will pay to hire outside labour (set up a firm), and inferior production possibilities will not be chosen. Under perfect competition, the boundaries of the household and social production possibility sets must coincide, since firms will compete for labour and the wage will represent the marginal revenue product of labour throughout the economy. If, as is likely, the most technically efficient production is carried on outside households by firms, it is allocatively efficient for households to supply wage labour rather than produce goods, and it is usually assumed for convenience of analysis that this division of enterprise is the case. Both the individual and the aggregate supply of labour are thus determined at the point where the marginal utility of leisure as a pure consumption activity equals the wage, which equals the marginal revenue product of labour. A corollary is the definition of

voluntary unemployment as a refusal to accept a wage less than the marginal utility of leisure; this may be distinguished from non-employment by the example of collective bargaining, where an individual's preference may diverge from the union's.

This work/leisure perspective may be relevant to an advanced urban industrial society in which households have no independent means of production and derive income solely from the supply of labour or other factor services to the market and from transfer payments. Conversely it neglects domestic production of all kinds, including the reproduction of the household. When labour is homogeneous, all forms of domestic activity are tacitly assumed to represent consumption with positive utility, since no leisure would be taken if it offered disutility. The supply of labour to each firm is perfectly elastic (it cannot reduce wages without losing all its workers) in the absence of restrictive practices, and the aggregate supply curve of labour has a positive slope, reflecting either the increasing marginal utility of leisure for an individual household able to vary its working time continuously, or a continuous spectrum of households with different reservation wages at which they enter the labour market. If the income effect dominates the substitution effect, the supply curve may bend backwards, and it may have a lower bound set by welfare benefits.

Since in practice both labour supply and demand are heterogeneous across individuals and across space, the productive activities of training and job-search ('frictional unemployment') are sometimes confused, unhelpfully, with leisure. Both training and job-search involve working time: the time to acquire additional skills and the time needed in practice to re-allocate efficiently each type of labour to the demand, after shocks to technology or preferences. If work and leisure are consistently defined, the household derives no more direct utility from training or job search than from other work, allowing for the principle of net advantage: these represent investments of foregone earnings which are expected to offer a net gain in terms of goods purchased. Further practical qualifications arise in empirical applications, from costs of mobility and from costs and asymmetry of information, but full employment competitive equilibrium remains the usual theoretical benchmark.

The major theoretical qualification to this analysis stems from Keynes's concept of aggregate involuntary unemployment as a state in which, after allowing for voluntary and frictional employment, basic labour is unemployed even though the market wage exceeds the marginal utility of leisure. In Keynes's *General Theory* (1936) aggregate

employment is limited not by the marginal utility of leisure but by effective demand. This means that the marginal utility of leisure is not a binding constraint in the individual optimisation problem faced by the unemployed worker. The household production possibility set may include a range of activities that yield less than the market wage, but offer more than the marginal utility of leisure. In other words, the household may choose an activity which is inferior (less technically efficient than those in which employed workers are engaged), but is still preferred to additional leisure. One implication is that an increase in the price of labour will result, not in an allocatively inefficient substitution of work for leisure, but an increase in welfare through the substitution of a more, for a less, technically efficient production activity. Furthermore, if involuntary unemployment is combined with a lack of competition between employers for labour, competition between workers may mean that involuntary unemployment leads, not to rationing and segmentation into formal and informal labour markets, but to a reduction in the wage of those in employment to the level of income achievable by those self-employed in inferior activities. This 'employer monopsony' will be the subject of the next sub-section.

In an advanced urban industrial economy, the unemployed usually have no independent means of subsistence and are dependent on welfare benefits or non-wage income. The only alternative activities in their production possibility sets are training and job-search, neither of which can relieve involuntary unemployment of basic labour in the aggregate, although they may benefit particular individuals and lead to turnover in the pool of unemployed. It is not difficult to conceive of examples of inferior training and job-search activities. In a rural agricultural economy, or one with no unemployment benefit, unemployment in this form is exceptional; the norm is under-employment on the farm, self-employment in petty trade, and non-market domestic work.

The labour market supply decision of a low-income self-employed farmer or artisan is unfortunately best understood as placing no value whatsoever on leisure. In the case of a typical low-income household without access to welfare benefits, all hours available (within physiological and social limits) are devoted to some form of productive activity. In an urban environment this may include production of goods using inferior technology from which the net return to labour is less than the market wage in the formal sector. However, much production, especially in a rural

environment where subsistence agriculture is an option, may not be undertaken for the market at all. The decision to supply goods or labour services to the market will be based on the value of the alternative of working to produce for direct consumption or use. '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.

In these circumstances the household's supply curve of labour services or goods for the market may indeed show a positive slope or price elasticity, but not because of the rising marginal utility of leisure foregone. The initial supply price may be very low, if indeed some labour is completely idle or engaged in domestic production of no real value even to the household. The supply price will rise as the household withdraws labour from increasingly productive alternative activities. At a certain point it may, for example, pay the rural household to give up subsistence farming and derive its income solely from cash crops or wage labour. The shantytown household is likely to derive income from a number of production and trading activities so that a rise in output of any one product requires the displacement of its least profitable activity.

Matters are complicated by income as well as substitution effects. Most prominently, an increase in the price of labour may be associated with ambiguous effects on child labour and education. At a level of income at or below bare subsistence, all members of the household must produce goods for immediate consumption in order to survive, and the household is unable to finance investment in education (Maseland and de Vaal 2003). Further up the income scale, children's education may still suffer when the price of labour is seasonally high. Nevertheless, it is typical of many low-income households that priority is given to children's education as soon as income rises above a minimum level, so that the household labour supply curve will have a negative slope within a certain range.

In line with the standard practice of economic theory, based ultimately on the conditions for stable competitive equilibrium, this paper assumes that in aggregate the substitution effect dominates the income effect so that the labour supply curve has a positive slope. The purpose of this sub-section has been to base this positive slope on a micro-economic trade-off against inferior productive activities rather than leisure.

Imperfect competition: the demand for labour

The circumstances in which local Fair Trade organisations emerge are characterised by a lack of competition for labour in aggregate, compounded by a lack of competition from the entry of new firms into particular markets. This sub-section uses the theory of employer monopsony to identify the economic effect of the local Fair Trade organisation in these circumstances, developing the work of Pigou (1932:556--563), Robinson (1933:292--304) and Meade (1982:44--57)¹. The key assumption is a fixed number of employers in a given labour market.

Figure 1 plots on the horizontal axis units of basic homogeneous labour (N) supplied by households to a particular local market, and the wage-unit or money earnings for each unit of labour (p,w) on the vertical axis. This measure of labour excludes domestic work not traded on the market. Earnings include the net proceeds from the sale of goods, after deducting the cost of external inputs, by self-employed households, as well as wages for labour services. The labour supply curve (W) plots the earnings of the marginal unit of labour as the total amount of labour supplied to this market increases. As discussed above, this supply curve slopes upwards as labour

¹ The theory of employer monopsony has since progressed from the static partial equilibrium model presented here to stochastic general equilibrium models of dynamic monopsony and oligopsony, where oligopsony means employers are atomistic but still set wages. Manning cautions that:

If a theoretical paper claims a strong conclusion about the direction of [allocative] inefficiency in the free market equilibrium, then this is almost certainly because they have not considered a rich enough model in the sense that there are not enough 'marginal' decisions to be influenced by incentives. (Manning 2003:70)

The application of the traditional static monopsony model to Fair Trade appears reasonably secure for two sets of reasons. Firstly, monopsony is believed to be an appropriate representation of the circumstances of local markets addressed by Fair Trade, although this paper cannot say whether these conclusions still hold under oligopsony. Secondly, in this model the slope of the labour supply curve reflects heterogeneous reservation wages (different rates of return to domestic labour) under involuntary unemployment, rather than frictions preventing a labour market from clearing (apart from those restricting households to their local market).

is withdrawn from inferior productive activities and is drawn linear for illustration, without loss of generality.

The assumptions of an isolated homogeneous labour market with a fixed number of employers and that wage labour and self-employment are equivalent imply 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. They also mean that a state of involuntary unemployment results, not in a queue of registered unemployed seeking jobs in the formal sector of a segmented labour market, but in a market-clearing wage based on inferior production possibilities.

All sales are assumed made to a single employer (including in this term the buyers of products from small-scale self-employed households). The MRPL curve represents the marginal revenue product of labour, the value which the employer obtains by selling the output of the marginal unit of labour employed. The vertical distance between the MRPL and W curves is the profit mark-up on the value of the marginal unit of labour. The MRPL curve is here drawn sloping downward on the assumption of diminishing returns in production rather than imperfect competition in product markets, and again linear for simplicity.

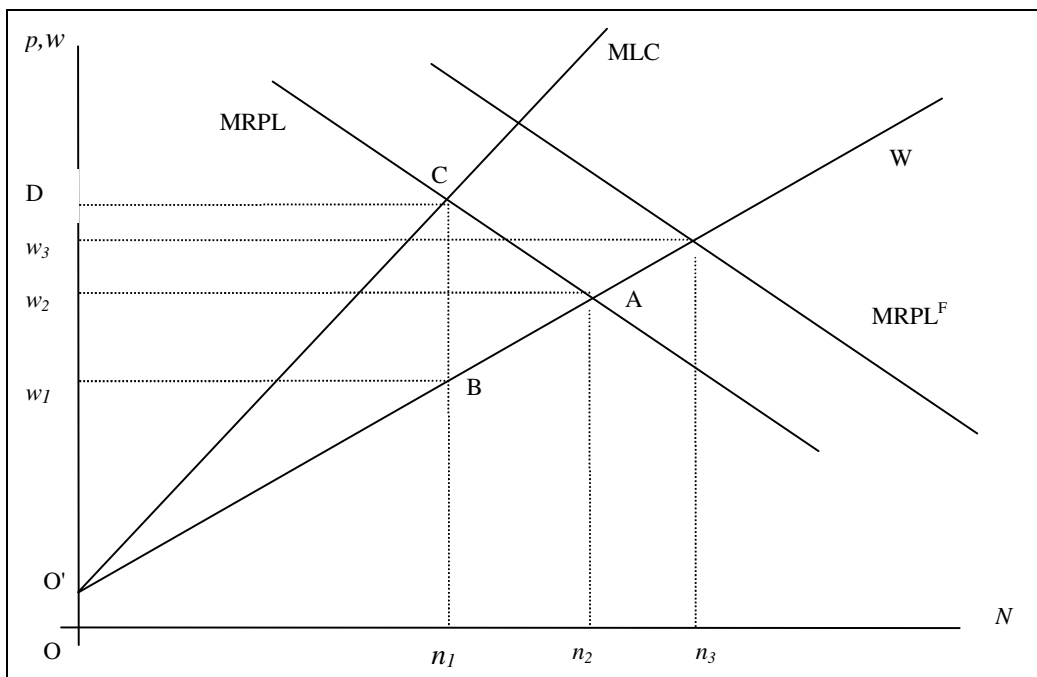


Figure 1 Employer monopsony

Now if the employer maximises profit, orders will be placed or employment offered at the level where the marginal revenue product equals the marginal cost of labour. This will be n_2 in two polar cases, those of perfect competition² and discriminating monopsony, in which employers make separate deals with each producer. An example of the second case is an employer travelling around buying small quantities of goods (e.g. cocoa or coffee beans) from each remote individual farmer (this is quite apart from overt cheating, 'unfair trade' in the sense recognised everywhere). In this case the total earnings of all the producers are equal to the area under the W line, marked by On_2AO' . The employer's profit is the area between the MRPL and W lines. This differs from the case of perfect competition where the producers' earnings are the whole rectangle formed by On_2Aw_2 , since all producers receive w_2 , the employer's profit being reduced accordingly.

Discriminating monopsony is more difficult if all the workers are brought together under one roof or the farmers bring their produce to a single collection point, and particularly if there are regular organised markets with local demand from other households (the supply of labour shown on the horizontal axis must then be measured net of supply to other households). In those circumstances, given the assumption that all workers are substitutes for each other in some ratio, it is hard even for the most brazen employer to pay significantly different prices or wages for the same work, particularly if it is piece-work. This means that the wage or price is set by the marginal unit of labour, that all units earn the same wage or price, even though the other workers would have been willing to work for less, and that the cost to the employer of hiring each additional unit of labour is not only the wage required by that worker, but the cost of increasing the wages of all the others. This marginal labour cost is shown in the diagram by the curve MLC, with twice the slope of W.

² It should be noted that in a state of involuntary unemployment the competitive equilibrium co-ordinate (n_2, w_2) does not correspond to the Pareto optimum, which may be represented instead by the co-ordinate (n_3, w_3) , with a higher marginal revenue curve based on full employment (MRPL^F). A state of full employment elsewhere in the economy would make local monopsony an exceptional case, since outside employers would have a strong incentive to compete for labour even in isolated areas. See also the section on the Fair Trade premium.

This means that the employer or buyer will hire labour only up to n_1 where $MRPL = MLC$, the point C. Fewer workers are employed ($n_1 < n_2$) and they all receive the same wage (w_1) which is less than w_2 . The workers' total earnings are now represented by the region On_1CO' , which equals in area the rectangle On_1Bw_1 . The area between the MRPL and MLC curves now represents the total employer profit. The monopsony rent is represented by the rectangle w_1BCD .

The traditional remedy for employer monopsony is a trade union or minimum wage, which operates by making the labor supply curve downwardly perfectly elastic. The primary source of monopsony is the ability of an employer to reduce wages by reducing employment, which a union or minimum wage can prevent as effectively as perfect competition. This is illustrated in Figure 2 by the horizontal portion of the MLC^U curve; note that the upper portion is parallel to the MLC curve, but shifted to the right. The entry of the union creates a new position of equilibrium (E) where $MRPL = MLC^U$ (no longer the monopsony position C) creating an incentive for the employer to bid up the market wage and increase employment above n_1 . If, as is likely, the union or minimum wage follows the market and ratchets up, MLC^U will shift upwards and to the right (not shown), and employment and the wage will converge on the competitive equilibrium (A).

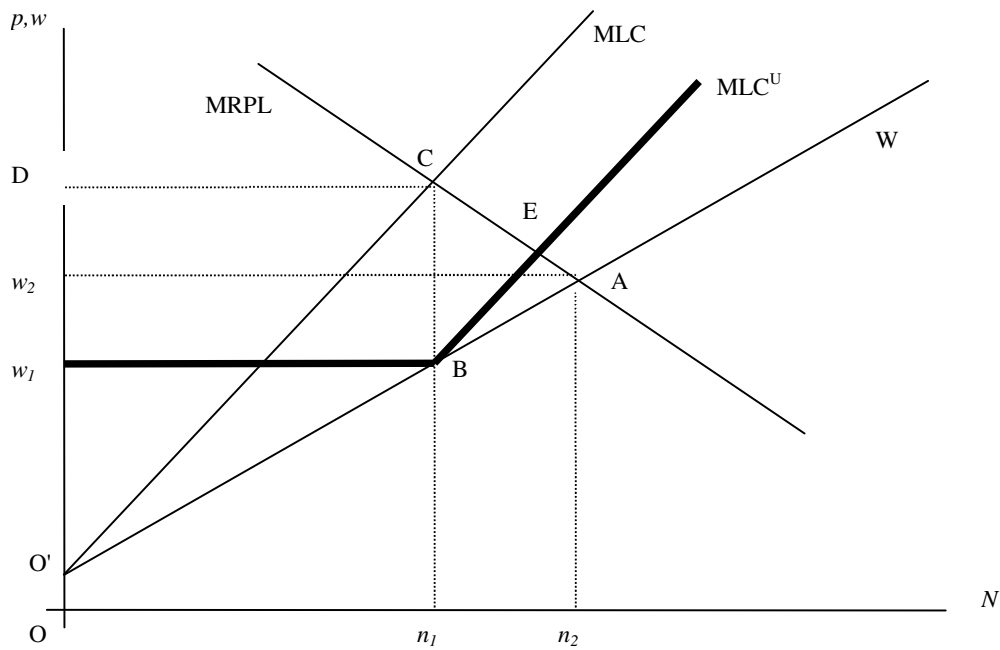


Figure 2 Effect of union below competitive wage

Should the union seek instead to capture all or part of the monopsony rent at the initial level of employment n_1 , there arises not only a kink but a major discontinuity in the labor supply curve (see Figure 3). Non-unionized workers represented by $(n_4 - n_1)$ are happy to accept employment below the union wage (note the relative position of W) and the employer has an incentive to employ them (note the equilibrium position E). The incentives of these non-unionized workers and the employer thus coincide and conflict with those of the union, leading to pressure on the union to reduce its wage. Both employer monopsony and union monopoly are disequilibrium states if there is freedom of association as well as freedom of enterprise.

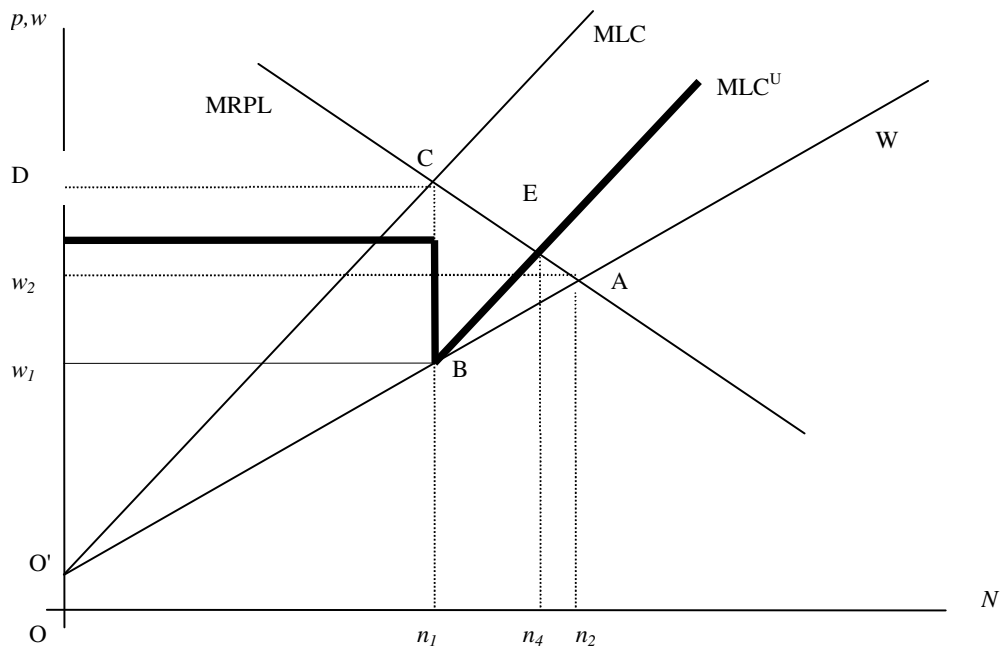


Figure 3 Rent-seeking by union

Fair Trade can then be understood principally as an alternative private sector remedy against employer monopsony for independent producer households or other workers who cannot form a pure labour union. For example, the workers or farmers may be organised into a co-operative that pays the producers equally, an amount equal to the market price w_1 on delivery of the product to the co-operative, with a dividend from profit at the end of the season. Alternatively, many local Fair Trade organisations are not organised as co-operatives, but 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. The analysis suggests that it is not necessary for the local Fair Trade organisation to hire the existing employed workforce in order to improve their position. If the local Fair Trade organisation is able to hire workers made redundant by monopsonistic attempts to reduce wages, it has the same effect as a union, minimum wage or new competition of making the labour supply curve downwardly perfectly elastic, thus benefiting the existing workforce³. If the employer does not increase employment above n_1 but merely accepts the reduced rent, the local Fair Trade organisation can increase the wage to w_2 by employing labour equivalent to the segment $(n_2 - n_1)$, and earn a profit represented by the upper half of the triangle ABC above the line Aw_2 in Figure 2. Even if the local Fair Trade organisation itself acts monopsonistically (e.g. the case of a closed co-operative, although this is prohibited by international Fair Trade standards), employment will rise to a level between n_1 and n_2 corresponding to point E in Figure 2.

Imperfect competition: the supply of inputs

The trade-off between market and inferior production is affected by the cost of inputs such as the raw materials and equipment used in production for the market by self-employed households. Where inputs have to be purchased in the market, imperfect competition can arise in the supply both of production goods and finance (see Welsh et al. 1989 for several case studies, also Remenyi 1991:43--50).

For example, the supply of agricultural inputs in a given area may not be competitive, so that farmers pay monopoly rents for seeds and fertiliser 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. Artisans engaged in piece-work at home are typically provided with raw materials 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. Local Fair Trade organisations may provide a workshop with equipment where artisans can work together and draw from a common stock of raw materials.

³ This result does not appear to require the assumption of efficient rationing in the sense of Becchetti and Adriani (2004), that the local Fair Trade organisation must employ the workers with the lowest reservation wages.

Of equal if not greater significance is the household's cost of finance, which may be either direct or indirect. The farmer 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 and no right of redemption by 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). Such arrangements may give the supplier of the inputs or buyer of the output a monopoly rent. Apart from such direct finance costs, the household may face a high indirect opportunity cost of finance (whether as borrower, or conceivably, as lender) in the absence of competitive financial services. Decisions to invest cash in production will then face a high hurdle rate.

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

In terms of Figure 1, without perfect competition or intervention by Fair Trade and microfinance organisations in the markets for productive inputs, the labour supply curve shifts to the left and the level of market relative to inferior work is reduced further below the competitive equilibrium.

FAIR TRADE ORGANISATIONS AND THE PRODUCT MARKET

So far, this analysis has been confined to a single local market in which there is no logical difference between wage labour and self-employment. The sale of a product by a household has been treated as equivalent to the payment of wages by piece-work, on the assumption that the employer sells either a different good or in a different location, neither of which can be supplied by the small-scale producer. On the strength of this difference in technology, standard practice is to refer to the market supplied by the employer as the 'product' market, and the local market supplied by households as simply the 'labour' market, and the net proceeds of labour, whether in the form of finished goods and services or labour alone, as 'wages'.

Even if product markets are assumed to be perfectly competitive in the short period, in the sense that there are no transaction costs and no individual firm can influence the market price by adjusting its supply offer, it does not follow that households and local Fair Trade organisations can easily enter the market to compete. To compete in a product market requires that a firm have an efficient technology, in the strict economic sense that both its short-period marginal cost and long-period average cost are no greater than the market price. It is precisely because individual households and local Fair Trade organisations do not possess such technology that they are unable to compete in the product market. To acquire a competitive technology requires capital investment in the widest sense, including stocks of raw materials, work-in-progress and finished goods, the necessary training in production, and what Marshall called the ‘internal organisation and external trade connections’ (1920:313), the intangible network of customary and contractual arrangements with counter-parties often referred to as ‘goodwill’. Plant and equipment are likely to be a relatively small part of the initial investment required to enter a market, becoming of major importance only as the minimum efficient scale of production increases. On the other hand, the establishment of a balanced portfolio of customers, suppliers and production methods is of crucial importance to the management of both insurable risk and uninsurable uncertainty. An efficient technology must allow the business to absorb customer, supplier and management failures, equipment down-time, climatic problems and other hazards, both insurable and otherwise. Under this heading may also be included the risk of price volatility, a matter of great importance in commodity markets.

If the product market is competitive, and the benefit of the local Fair Trade organisation is mainly its effect on the labour market, the case for entering the product market appears weak. However in practice a local Fair Trade organisation must combine access to the product market with its role as a source of local demand and supply for households. This may arise where the monopsonistic employer with access to the product market refuses to buy from organised labour, whether in the form of a trade union or a local Fair Trade organisation. Such refusal may be the result of technical inefficiency, or a matter of strategy. If the employer is inefficient (its average costs exceeding its marginal costs), it cannot stay in business without the monopsony rents from restricting employment and thus cannot afford to buy from organised labour (see Robinson 1933:299). Strategically, an efficient employer may

be able to deter competition from local Fair Trade organisations and protect its monopsony rents by refusing to buy from them. In such a case, a local Fair Trade organisation can exist only if it can also access the competitive product market and thus, even if initially less efficient than the employer, it may yet deliver a net gain to households, through eliminating the monopsony rents in the labour market. The association of Fair Trade with global product markets rather than simply the organisation of labour in local markets can thus be understood. The benefits of Fair Trade in overcoming imperfect competition in the local labour market are in practice not realisable without competing alongside the monopsonistic employer in the competitive product market.

This brief discussion of the complex requirements of an efficient technology illustrates the formidable barriers facing an existing or potential local Fair Trade organisation that needs to enter the product market, leaving aside the possibility of non-economic opposition from a monopsony employer. Any suggestion that there are easy pickings for local Fair Trade organisations through undercutting inefficient competitors in the product market should be dismissed. 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. This is the context in which the distinctive international dimension of Fair Trade becomes relevant, in the form of the importing organisation, generally known as a 'Fair Trade buyer'.

The full integration of global production and distribution that is characteristic of transnational businesses has yet to emerge at this stage of the Fair Trade movement. Yet the Fair Trade partnership between buyers and local organisations bears some resemblance to the relationship between the different divisions of a transnational. There are crucial differences, too, but in economic terms the partnership with a buyer offers the local organisation similar benefits in reduced performance risk (that of outright contractual default and opportunistic renegotiation), greater sharing of production risks, longer-term contracts and planning horizons, and access to finance. The buyer does not have the transnational corporation's control over the production

process, yet buyer support with training, design and quality assurance is common, often provided by a sister development charity with access to grant funds.

This analysis therefore suggests the main benefit of the Fair Trade partnership to the producer household is in the process of investment in equipping the local organisation with an efficient technology, i.e. in creating and maintaining the ability of the local organisation to compete in the product market. The buyer reduces the local organisation's production costs through helping it reach minimum efficient scale and overcome lumpiness in production methods, reducing risk and providing finance, creating additional income for investment and the opportunity to learn by doing. The buyer may depend, to a greater or lesser extent, on the support of ethical consumers who are prepared to absorb some of the risks and costs in order to achieve their own social goals through participating in Fair Trade. The commitment of ethical consumers may extend to accepting the risks and costs of equipping a buyer with an efficient technology. The partnership with one or more buyers cannot in practice, and should not in principle, be the dominant source of demand for the local organisation in the long term, so long as they remain formally independent of each other. The local organisation must aim to become equipped to compete independently in the product market, since the buyer cannot give an open-ended and permanent commitment to purchase, irrespective of the demand conditions in the buyer's own markets, and should be explicit as to how the trading relationship may end at some point (Traidcraft 2002:4).

The Fair Trade partnership is itself vulnerable to market forces. Extreme examples are when buyers are forced to cancel or fail to renew purchase contracts because of their own financial difficulties (including insolvency, *cf* Pueblo to People (US) in 1997, Bridgehead (Canada) in 1998), and when local organisations default in supply, either for similar reasons, or when in conditions of price volatility the organisation itself or its producer households default on forward contracts to take advantage of spot gains. More subtle problems, similar to employer monopsony, arise when a buyer objects to the local organisation supplying the buyer's competitors, including buyers outside the Fair Trade movement. There is no escaping the fact that conflicts of interest will arise in a competitive environment, and that sometimes both equity and its own long-term interests require the local organisation to take into account the buyer's interests and previous investment.

On this note it is worth recording cases where the local organisation is stronger than the buyer (e.g. CORR Bangladesh and Tearcraft/Traidcraft, see Adams 1989), and where the buyer can work initially only with competitive local organisations in order to establish itself in the product market (e.g. *cafedirect* and COOCAFE Costa Rica, see *cafedirect* 2004:1). This reversal of dependency is at odds with the usual stereotype, but is consistent with the analysis that the benefits of Fair Trade for 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 depend on them.

THE FAIR TRADE PREMIUM

So far, this paper has not assumed that the buyer pays the local organisation more than the market price. The economic benefit of Fair Trade thus flows from improving competition for labour and from long-period access to product and credit markets. Enhanced competition, including the entry of new firms, would have a similar effect, so that Fair Trade can be seen as a complement and substitute for competition when it is weak. This contrasts with the philanthropy and trade theory models, which, for analytical purposes, define Fair Trade solely by the payment of a premium over the market price. Nevertheless, in the contemporary state of supply and demand, a Fair Trade premium is indeed often observed in the transaction between buyer and local organisation.

This paper does not consider the case for a premium as a ‘second best’ measure to offset the effect of differential trade protection in processed and unprocessed commodities; nor as compensation, by attempting to set a minimum price based in effect on ‘long-period equilibrium cost of production’, for the absence of futures markets of a sufficiently long term to match the crop cycle. This cycle occurs when high prices attract investment in new capacity with a long gestation period (e.g. coffee bushes), and low marginal costs deter the scrapping of capacity when prices are low. The absence of the necessary futures markets leads to incorrect expectations and a dynamic misallocation of investment, with consequent disequilibrium swings in commodity prices that damage producers who would be efficient in long-period equilibrium, if it could ever be attained and they could survive the cycle. The following argument takes free trade as the benchmark and is limited to the short

period, i.e. the equilibrium level of employment and output with a given level of production capacity. Economic theory cannot otherwise compare the efficiency of one position of long-period disequilibrium with another, and the use as a benchmark of the Marshallian concept of long-period equilibrium itself (involving both full employment and fully adjusted capacity) is rhetorical rather than scientific, in the evident absence of the requisite futures markets to co-ordinate long-term investment. In other words, this argument does not address the pragmatic or moral case (it cannot be based on pure economic theory) for or against Fair Trade based on countervailing protection or long-period cost of production.

In terms of Figure 1, a premium shifts the MRPL line upward towards, or possibly beyond, $MRPL^F$, the marginal revenue line associated with full employment and the Pareto optimum. Note that full employment is a state where the wage equals the marginal utility of leisure, and not only of inferior production activities. Should the premium take the MRPL above $MRPL^F$, there may⁴ be a cost in terms of allocative efficiency. Below this level, an increase in MRPL and employment to a level between n_2 and n_3 unequivocally represents an increase in allocative efficiency, through the substitution of a more for a less technically efficient production activity.

A premium may⁵ therefore be inefficient when the economy is in a state of full employment, so that labour is drawn from both local and wider labour markets into over-producing for a particular product market, reducing prices and incomes for unsubsidised suppliers to that market. This is the classic result in the economics of taxation and tariffs. Alternatively, if the income effect dominates the substitution effect, the premium will result in households taking more leisure, courtesy of the ethical consumers or other source of the premium. It is self-evident that the full employment of comfortably off producer households does not represent the circumstances in which Fair Trade emerges, so that this particular concern need not

⁴ The cost of social and environmental externalities internalised by the local Fair Trade organisation may mean that the full employment competitive equilibrium does not represent the social optimum.

⁵ Where the premium is ring-fenced by the buyer and paid into a separate development fund there can be no adverse consequences for efficiency even in this case.

detain us (although an important exception is the release of children from work to go to school).

In the case where the local Fair Trade organisation is too small to affect materially the elasticity of the labour supply to the monopsony employer, the earlier argument does not apply, and the premium may become the main distinguishing characteristic of Fair Trade as suggested by other writers. In the case of a single producer (Leclair 2002) the premium may induce extra intensity of labour, but this will improve efficiency under conditions of involuntary unemployment. This leads us to the interesting case of a local Fair Trade organisation with a fixed capacity to employ labour, for physical or managerial reasons, where any premium accrues, not directly to households through an increase in the demand for labour, but as a rent to the organisation. This may be an appropriate representation of some of the smaller organisations, engaged particularly in handcraft production and highly dependent on Fair Trade buyers, associated with one historical form of Fair Trade. Alternatively, it may represent the situation of a large agricultural co-operative for which international Fair Trade constitutes a small proportion of sales and does not affect the farm-gate price offered to households, although the co-operative may already have broken the monopsony in the labour market. In either case, the premium is equivalent to a donation to the local Fair Trade organisation. The application of this rent (whether positively, as a dividend to labour, investment in diversification, or collective provision of health and education services; or negatively, in supporting technical inefficiency) raises other questions about the effectiveness of Fair Trade organisations relative to donor agencies as a channel for poverty alleviation and changes in the distribution of wealth, but it is clear from the earlier argument that it has no consequences in terms of efficient allocation.

CONCLUSION

This paper has used the theory of competitive equilibrium to analyse the economic efficiency of Fair Trade. Keynes's concept of involuntary unemployment permits an understanding of the labour supply decision as a trade-off between market and inferior domestic work or petty self-employment, rather than between work and leisure, and of the difference between the competitive equilibrium and the Pareto optimum. The primary effect of large-scale Fair Trade is the elimination of monopoly rents in local

markets, for the labour services or products of self-employed households, and for their productive inputs. Further research on Fair Trade will be the more fruitful if it takes account of this perspective, and should avoid some of the red herrings produced by the use of inappropriate analytical tools. This applies also to some of the policy conclusions reached by both supporters and critics of Fair Trade.

Fair Trade should not mean paying producer households more than the value of their marginal product. Fair Trade tends to increase production so that households benefit by more than the increase in the price of labour, but the latter increase bears in general no direct relationship to any Fair Trade premium paid by the ethical consumer. The increase in market production represents a move towards the Pareto optimum of full employment equilibrium under perfect competition, since it represents a re-allocation of labour away from, and not towards, inferior productive activities. The ethical consumer and the Fair Trade premium are not the core of Fair Trade, but the long-term commitment of Fair Trade buyers to local Fair Trade organisations, underpinned by the preference of the ethical consumer, is a valuable, and sometimes essential, contribution to the investment required by local organisations and their households to equip themselves with an efficient technology in order to compete in global markets.

Fair Trade is economically efficient in any plausible circumstances and in a state of aggregate involuntary unemployment compensates for a lack of competition in the markets faced by households, while encouraging the expression of non-market values of solidarity at local and global level. Properly understood, Fair Trade complements and strengthens the competitive market and has nothing to do with protectionism. Fair Trade is indeed an essential complement for any free trade policy that includes a genuine concern for the welfare of the poor.

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