Laissez-Faire Trade?
The Economics of Fair Trade

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It is not difficult for Americans to find Fair Trade Certified products in grocery stores nor is it uncommon to hear a person touting the great service it does to the world. However, the public as a whole does not know very much about the processes by which Fair Trade goods come to them beyond the simple, "people get paid a fair amount for their goods rather than the exploitive amount that they would receive otherwise". The Fair Trade Movement seems like it is beneficial to society, and it may or may not be. Yet for better or worse, the organizations that it consists of hold substantial influence over the markets for coffee, bananas, apparel, and to a lesser extent, jewelry, furniture, and other products. Unlike other trade groups, Fair Trade organizations have an emotional basis that others like oil or tire conglomerates do not. Namely, there is an appeal to the consciences of consumers to do right to the poor producers of goods in the Third World. In contrast, normal businesses like oil or tires are simply businesses that are only guided by the desire to make profits. But the issue of Fair Trade is much more complex than might be initially expected and considering the general lack of understanding of how such organizations affect the market for goods, the purpose of this essay is to explore what "Fair Trade" is and how it works.

First, what is "Fair Trade"? It is important to distinguish the concept from the group of organizations. The founders cleverly named their movement "Fair Trade" so that the two would become synonymous in the minds of consumers. "Fair Trade" is the name of a group of organizations, like the Fair Trade Federation, Fair Trade USA, Equal Exchange, Ten Thousand Villages, and others which serve to connect producers of various goods in Third World countries with consumers in America and other First World nations in an effort to raise awareness of the poor and help them overcome their poverty. To that end, certification organizations decide what a "living wage" is and making sure those producers are paid that amount for their good. On the other hand, the idea of "fair trade" is just as it sounds, trading fairly with people. A question that should naturally arise is: how is "fair" defined? This is a huge question that is at the heart of this issue. After all, who is to say what price is fair? The Fairtrade Foundation, which is based in Great Britain, has a short explanation on how prices are determined on its website[1]. The price is not fixed but rather is called the "Fairtrade Minimum Price". This acknowledges that sometimes market equilibrium prices are higher than what a certifying organization might set and in response to that, the Fairtrade Foundation dictates that when this happens, purchasers must pay the higher market price. Now, if the market price is lower than their predetermined price, then the coffee growers are guaranteed that minimum price at least. In this situation, it is a non-binding price floor. In other situations, when the minimum price is above the market equilibrium, it is a binding price floor. Analysts in the organization research how much it costs farmers to operate their businesses and, "[the price] is set at a level which ensures that Producer Organizations receive a price which covers the cost of sustainable production for their product." Beyond that, the members of a co-op will sometimes meet to negotiate a premium that is added into the price beyond the minimum. This extra money is invested in social and economic development projects[2]. So it would be incorrect to make a blanket statement and say that the

Fair Trade Movement is bad, because it does do some good for some people. This will be expounded upon later in the paper.

It is not always easy for a small farmer to join a Fair Trade cooperative, which is also discussed later, but if they are able to be part of one, their supply chain looks different than the regular market's. Assuming that there is a regular free market in the country, a farmer will sell his beans to a middle man. They then get sold to a processor/exporter who sells it to a U.S. broker then to a coffee company, food distributor, and store/café. Then finally after all those transactions, the consumer purchases it. With a Fair Trade organization, the chain looks like this: a famer sells his beans to a cooperative which then sells them to an organization like Equal Exchange. Then they are sold to a store of café and finally to consumers. The reduction of middlemen decreases costs and, as a result, allows more of the profits to be passed on to customers[3]. This is, in theory, how Fair Trade works.

The Fair Trade movement does something interesting: it raises the price of the coffee above what the market equilibrium would dictate. This does two things to the coffee market. First, it causes an excess of suppliers. Second, it causes a shortage of demanders. Imagine that the market clearing price for coffee beans is a pound of coffee for a dollar each. An organization like Fair Trade USA might dictate that to be "fair" for the farmers, the price will have to be two dollars per pound and so they begin to sell their certified coffee at that price. An interesting thing happens now: the individual farmers make more money per pound of coffee than they before, but they sell a lower quantity because fewer people are willing to pay that much for it. Graphically, the amount that coffee growers' supply increases because they hope to be able to sell more. But the amount of beans that people want to buy goes down because fewer people are willing to pay the new price of two dollars. This creates an inefficient surplus in the market.

This excess of suppliers becomes a problem in other areas as well. When a farmer, or any worker, is not making enough money to subsist, he has an incentive to look for a different job. When the market clearing price is not enough to survive, he will sell the farm and move to the city, or perhaps try to grow a more profitable crop. Transitions like that are not easy, admittedly, but they are not impossible and it would be unfair to not believe that the farmer is capable enough to do it. Now when the price is artificially high, the farmers will stay in the coffee business when they should be in some other one. This principle does not just apply to Third World farmers, but to workers of all occupations, and it makes sense intuitively. If a person isn't making enough to survive in his current occupation, then he will want to do something else. But if he is making enough, then there is no reason to change. Quite the opposite has been true in the past several years. In a Cato Institute paper[4], Brink Lindsey writes that growing coffee has become more profitable for many reasons, not the least of which being new technologies that allow cheap Robusta coffee to have its bitterness extracted and so allowing it to taste like the more expensive Arabica type. Countries like Vietnam have dramatically increased their production of coffee in recent years as a result of this technology. All these new producers, just as market forces dictate, cause the market price to go down to clear the huge influx of supply.

Jeremy Weber interestingly pointed out in another paper for the Cato Institute[5] that the main problem with the excess supply is not necessarily that "large quantities of coffee are dumped on world markets", but instead "that an excess supply results in increased barriers to entry and increased competition among producer organizations for a limited number of Fair

Trade contracts". This is especially bad for small farmers because they can't really compete with large producers both because of the costs of start up and because of the costs of certification. To differentiate a product further, and woo the Fair Trade organizations, coffee producers will also try to get their beans organic certified. This "dual certification" is great for customers who consider themselves conscientious since by purchasing these products they are both, in theory, helping the environment and small growers. But ignoring the realities of the market and pretending that ideology alone is powerful enough to move coffee beans from the grower to the drinker is simply naïve. There are market forces that govern trade and the Fair Trade movement has not been above their influence.

One problem that stems from this, and that has been a bane to the Fair Trade movement, is the problem of un-ideologically committed members. Corporations see the idea of Fair Trade and/or organic certification as an opportunity to charge more for their products, which is certainly the case. The large companies have resources on their side and, as a result, are free to out-bid the individual farmers for expensive certification contracts. In the end, then, it is the established large businesses that sell the most "Fair Trade Certified" coffee, not small farmers or local businesses. This is the case in the normal free market as well, but regular companies don't masquerade as champions of the poor like in Fair Trade movements. Indeed, large corporations harness the influence that the Fair Trade movement holds to sell even more of their products, and at higher prices, because they are being sold to customers who think they are doing something ethical.

There is a widespread misconception in which products that are not "Fair Trade Certified" are automatically "unfair trade", that they came from some destitute family in a poor nation, and that the family was exploited by greedy capitalists. Soon images of sweat shops and children working long hours in coal mines come to mind, but these are not the case. This may happen in some cases, but they are the exception rather than the majority. Consider that only 3.3 percent of the coffee in the United States was certified in 2007[6]. Now even if some of the farmers in the rest of the market had no choice but to be in the coffee growing business, it seems fair to say that a substantial amount of them still voluntarily in the coffee industry. They grow coffee because it is the best thing that they can do with their land, "Fair Trade" or not. The market equilibrium price is still fair enough for them. If it weren't, there would see a mass exodus of farmers from the industry until a new equilibrium price and quantity supplied is reached.

What would make a market equilibrium price better, for the world as a whole, than the usually artificially high prices of Fair Trade certified coffee? The Supply and Demand model is a simple, but incredibly powerful representation of how price paid and quantity supplied affect the way people produce and purchase products. Imagine a normal Cartesian coordinate system, a basic graph. The Y axis shows prices and the X axis shows quantity of a good, coffee in this case. On the graph are two lines, one which goes from the upper-left corner to the lower-right and one that goes from the lower-left corner to the upper-right. The first line is the "demand curve", this measures the quantity of coffee that people would be willing to buy at any given price. The second line is called the "supply curve". They intersect in the middle of the diagram. It measures the amount of coffee that suppliers are willing to produce and sell at any given price. What the graph shows is that at low prices, many consumers are willing to buy coffee, but few suppliers are willing to sell it. These preferences switch at the other end of the graph. At a high price, many suppliers are willing to sell their coffee, but few consumers are willing to buy it. What is the logic behind this?

Before continuing to the price, take a step back for a minute and consider why people buy coffee in the first place. They may like the taste or need the caffeine or any number of things. What determines the price that they will pay is the amount of value that they will get for it. If a person would get a dollar of value from a cup of coffee, he will spend up to a dollar for a cup because anything less than a dollar would mean that he was getting more value than he was spending. This is called a “consumer surplus”. Now if the price were two dollars per cup, then the consumer would not buy coffee because it would cost him more than the value he would get from it. Ultimately, the price which causes the buyers to demand the same amount as is being supplied is the most efficient because it maximizes surpluses for both producers and consumers and keeps there from being a shortage or excess of supply so none is wasted.

Turning to an almost entirely different topic, a lot of farms which are certified as “Fair Trade” do not meet the payment standards of the organizations. Hal Weitzman visited Peruvian coffee farms and wrote an article for the Financial Times in 2006[7]. He learned that four out of the five certified farms paid their laborers below the government’s minimum wage. This is not only illegal, but also “contravenes fair trade standards”. Chris Wille, who is the chief of sustainable agriculture at the Rainforest Alliance, responded that “the low pay issue wasn’t picked up in our audit because it wasn’t done at harvest season”. This certification problem with Fair Trade organization is not that they have some malevolent intent to take advantage of conscientious consumers by falsely advertising that their coffee was grown by laborers who were paid fairly, but they’ve simply overcommitted in trying to do something that is not possible. It is possible to make a statement that the coffee came from a farm in which the laborers had the benefit of fair wages, but this is incredibly difficult to enforce.

Conversely, the Fair Trade Movement has been a great boon to individual producers. This is a fairly intuitive conclusion: if a consumer pays more for his coffee, the farmer who grew it will make more money for it. There are, of course, variations in the amount of money that gets to the grower depending greatly on the supply chains, transportation costs, and organizations involved. Despite all the faults of the Fait Trade system, there are still notable improvements in the cases of some individual farmers. Oxfam published a fascinating paper in 2001 which suggested that producers who sell Fair Trade products have a 28% higher income than they would otherwise[8]. The goal of Fair Trade organizations is not necessarily to supplant free trade, but to enhance it.

Perhaps advocates and humanitarians have been looking in the wrong place for "unfairness" and "exploitation" in the market. Perhaps the real culprits of unfair trade are tariffs and other barriers to trade. The Nobel Prize winning economist Joseph Stiglitz wrote an excellent book called Fair Trade For All[9] in which he does not advocate "Fair Trade" in the sense of Equal Exchange, Fair Trade USA, or any other advocacy group. He argues instead for the elimination of trade barriers, but not the entire elimination of regulation in trade. Laissez-faire, or "let do" in French, broadly means "leave alone" or "hands off". In economic policy, it entails no government intervention in trade or the normal operation of people and firms. History shows that open, or "free", countries tend to prosper more than countries that are "closed", or not free. Consider the United States and the former Soviet Union. Both were world powers after World War II, but the average Russian continued to be impoverished for decades under the Communist government while the citizens of the United States flourished in a post-War boom and which has, overall, seen the economy growing significantly ever since. Russia was much more isolated and had a highly controlled economy because of its Communist government. As a result, it continued to be impoverished even though the rest of the world was growing at an unprecedented rate. In fact, the countries that have grown the most in the past 50 years have grown because they opened their economies up to free (or almost free) world trade. Some opened voluntarily like China. Others, like Japan, had it forced upon them after the World War II. Interestingly, Stiglitz notes that these countries did not develop to the level of prosperity that they attained by completely open and unregulated trade. He says they all had "trade regimes with varying degrees of liberalization" (Stiglitz 12). In other words, trading policies were adopted which were generally, but not completely, laissez-faire.

So what does all this mean for the coffee growing nations? It should be noted that small developing countries often have corrupt and oppressive governments, which may allow trade to a certain extent, but ultimately they hinder growth by taking revenue from them, either by forcing them to sell their products through a centrally controlled exchange. For the individual farmers, this has the same effect as the isolation that plagued the Japanese and Soviets in the past: they were kept poor. History shows us, however, that the strongest economic development comes from open borders. If the developed world wants to help the poor in the Third World, the best way would be to promote free markets and government reform. In the area of government reform, there should be an emphasis on becoming more democratic and more open to frictionless international trade. Instead of simply bandaging the plight of the individual farmers, as Fair Trade does, it changes the entire economy and the benefit is felt by the entire population.

Furthermore, the opening up of an economy makes its resources available to the rest of the world more freely and as a result, the whole planet benefits. This is what happened with Japan and now they enjoy exporting their cars to the rest of the world. At the same time, the world benefits from being able to purchase their cars. This free trade is positive-sum and everyone benefits from it. There is no reason that it could not happen with other countries as well. Unfortunately, this transformation is easier said than done. Yet as the world watches a dragon rise in Asia after decades of poverty because of increased international trade, perhaps it will take note and there will be some freeing up of restricted developing nations. Then we will see real progress in the global alleviation of poverty.

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