FAIR TRADE: AN ILLUSION?

Eric TOLLENS

October 2003

This paper (pdf) can be downloaded following the link:
This paper has been presented at the interdisciplinary course ‘Ontwikkeling en Culturen’, Maria Theresia College, Kleine Aula, October 21, 2003.

Prof. Eric Tollens,
Department of Agricultural and Environmental Economics, K.U.Leuven,
de Croylaan 42, B-3001 Leuven (Heverlee), Belgium
Tel.: +32 16 32 16 16, Fax: +32 16 32 19 96,
Email: eric.tollens@agr.kuleuven.ac.be

Copyright 2003 by Eric Tollens. All rights reserved. Readers may make verbatim copies of this document for non-commercial purposes by any means, provided that this copyright notice appears on all such copies.
1. Introduction

Fair Trade (FT) is not new or recent. It started some 40 years ago. Already in 1991, Max Havelaar\(^1\) coffee was sold in Belgium, following the Dutch example. In other countries, other names were used such as Transfair, Fairtrade and Rättvisemarkt. Now, 18 coffee brands, representing 30 types (origins) of coffee carry the Max Havelaar label in Belgium. Total Max Havelaar coffee sales in Belgium in 2001 were 582 tons; for bananas, a recently added product, sales were 924 ton in 2001.

FT was started by missionaries and the first FT products were sold in so-called world shops. Disadvantaged producers, and their representatives, out of ideology against the mainstream trade, set up their own marketing channel, in fact a niche market. But this remained very marginal as they could not address the mainstream market. This is how the idea for a label came about, such that labeled products could be sold in shops and supermarkets. The first labeling organization was the Max Havelaar Foundation in the Netherlands. Other labels were created in other countries and in 1994 they decided to collaborate, which gave rise to the Fair Trade Labeling organization (FLO) in 1997.

FT remains a marginal phenomenon in international trade, but growth is 20% or more per year and the list of products included under the FT label grows\(^2\). The following

\(^1\) The name of a book written by Multatuli (E. Douwes Dekker) in 1860, a writer who lived in Indonesia during the Dutch colonial days, and who described the exploitation of Indonesian coffee growers by Dutch traders.

\(^2\) Total FT trade in the world in 2000 was 220 million $ while total world trade was over 5.000 billion $. One can thus say that FT is only a drop in the ocean.
products are presently sold under the FLO-label: coffee, cocoa, bananas, tea, pineapple, sugar, rice, mango, honey, fruit juices, wine, chocolate. In fact, the list is growing almost every month. Also, most multinationals now have FT products in their product range, except two notable exceptions for coffee: Nestlé and Sara Lee (Douwe Egberts). Most farmer organizations or cooperatives that participate in a FT scheme can only sell a small part of their production under the FT label. Usually this is only 5% or less because demand for FT products in the North is still limited. For coffee in 2002, there were 144 farmer organizations on the waiting list of FLO and 177 active (see further for an explanation of FLO).

Development economists agree that FT is a superior instrument for poverty alleviation over handouts (social assistance) or typical rural development projects, as FT entirely relies on local efforts to succeed.

2. FT labeling and certification

Since FT products need to comply with strict criteria and norms, in 1997 a Fairtrade Labeling Organization (FLO) was created, headquartered in Bonn, Germany\(^3\). Today, FLO groups 17 national FT organizations, of which Max Havelaar, and introduced in 2002 a common label or logo (certification mark) to be used by all member organizations in North America, Europe and Japan. FLO aims to improve the position of poor producers and workers in developing countries by setting FT standards and by

\(^3\) FLO received the 2002 King Baudouin International Development Prize for their pioneering role in giving disadvantaged products and workers in the developing world the opportunity to participate directly and at fair trade conditions in international trade, through a system of certification, producer support, business facilitation, and consumer education.
controlling producers and traders through a certification and trade-auditing system.

FLO carries out three important activities:

* Guaranteeing standards
  - assessing the compliance of producers with FT standards;
  - assuring that FT benefits are used for social and economic development;
  - auditing FLO registered traders in order to make sure that the FT price reaches the producers;
  - assuring that the labels are used only on products coming from FT certified producers.

* Promoting producer support
  - strengthening their organization and production, e.g. quality upgrading, diversification, organization strengthening through advice and training.

* Business facilitation
  - FLO's product managers identify business opportunities, contact processors and distributors in the North, and try to enhance FT impact in commercial markets.

FLO standards must be met - by producers, traders, processors, wholesalers and retailers - for a product to qualify for the label. For consumers, it is the guarantee that their actions (purchasing) result in a better deal for poor farmers in the South.

There are two sets of generic producer standards, one for small farmers and one for workers on plantations and in factories. The first set applies to smallholders organized in cooperatives or other organizations with a democratic, participational structure. The second set applies to organized workers, whose employers pay decent wages, guarantee the right to join trade unions and provide good housing where
relevant. On plantations and in factories, minimum health and safety as well as environmental standards must be complied with, and no child or forced labor may occur.

Because Fairtrade is also about development, the generic standards distinguish between minimum requirements which producers must meet to be certified as Fairtrade, and process requirements that encourage producer organization to continuously improve working conditions and product quality, to increase the environmental sustainability of their activities and to invest in the development of the organizations and their producers/workers.

Trading standards stipulate that traders have to:
- pay a price to producers that covers the costs of sustainable production and living;
- pay a premium that producers can invest in development;
- partially pay in advance, when asked by producers;
- sign contracts that allow for long-term planning and sustainable production practices.

Finally, there are a few product-specific FT standards for each product that determine such things as minimum quality, price and processing requirements that have to be complied with. The certification unit at FLO-Bonn operates independently and has 38 inspectors, all people from the South, who oversee the application of FLO-criteria and the use of the label.
3. Ethical trading not the same as FT

Ethical trading is not to be confused with fair trade. For instance, the Ethical Trading Initiative formed in the United Kingdom in October 1998, is a forum of retailers, NGOs, trade unions and other bodies aimed at the development of common approaches to the formulation and implementation of codes of conduct (du Toit, 2001). Members developed a base code broadly based on internationally accepted labor and social standards, and a set of implementation principles setting out best practice in the adoption of the code (ETI, 1998). The base code of the ethical trading initiative includes:

- employment is freely chosen;
- freedom of association and the right to collective bargaining are respected;
- working conditions are safe and hygienic;
- child labor shall not be used;
- living wages are paid;
- working hours are not excessive;
- no discrimination is practiced;
- regular employment is provided;
- no harsh or inhumane treatment is allowed.

Thus, ethical trading is close to corporate schemes aimed at chain management and code harmonization within global commodity chains. In global agro-food trade, this includes CEPAA's SA 8000 scheme for labor standards, the euro-retailer fresh produce working group's protocol sponsoring for Good Agricultural Practices (EUREGAP), the Forest Stewardship Council's Framework for the certification of the sustainability of forest management practices in timber (FSC), and even the Hazard
Analysis and Critical Control Points food safety regime (HACCP). All these involve the development of generic, harmonized guidelines for in-company systems. All of them claim to be global standards and emphasize the importance of reliable and valid monitoring and verification.

4. Economic analysis of FT

There exists a lot of misconceptions about FT. In Dutch, it is called "eerlijke handel", a very poor translation as "eerlijk" or "honest" refers to an ethical concept of "not cheating". It implies that all regular trade is then dishonest, which of course is not true. The French translation is better "le commerce équitable", or trade with equity. The English term FT is in my view the best, as "fair" implies something which benefits everybody, which is equitable - a level playing field as Americans would say.

It is not easy to find a good definition for FT. In my view, it is trade which guarantees that the weakest link in the marketing chain, usually the farmer, or the plantation worker, receives an equitable or "decent" share of the value of the end product, under all circumstances. Many people would say that FT guarantees the producers a decent living standard, i.e. a price for his product that enables the farmer to cover his basic needs (food, shelter, health, education) and to live decently (and many sociologists-anthropologists will add: and in dignity).

But it is very difficult to define decent living standards and basic human needs, as they are very location specific and need to be judged against some peer group. Moreover, economists will add that nobody has a (divine) right to produce whatever he likes and request a decent living standard in doing so. If something is produced for
which there is no market demand, or which is in oversupply, market signals ("the price") should be such as to discourage the producer from further production. To put it in a concrete, actual example, if coffee prices are very low because of overproduction, then this must induce coffee producers to produce less, and to diversify their production. This is the golden rule in economics where prices are market signals that must coordinate production and consumption (supply and demand). Markets are coordination mechanisms where prices act as signals. If they perform this function well, there is price efficiency in markets as prices then play their proper role. This then explains why in liberalized, free markets, market information must be available to all market participants. Only then can markets work efficiently.

The drama in many agricultural markets, particularly those of perennial or tree crops (palm oil, rubber, cocoa, coffee, tea, many spices, etc.), is that once the crop is planted, which is the major investment, maintenance and production costs (picking of coffee, cocoa, … and on-farm processing) are relatively low cost and prices have to fall very low in order to discourage production. Farmers will continue producing (harvesting) as long as the price (which constitutes their marginal revenue) covers the marginal cost of production, which in many cases is just picking the fruit from the trees and preparing it for sale (hulling, fermentation, drying, grading, etc.). As these marginal costs can be very low, prices can fall very deeply before they discourage production.

Economists generally have many objections against FT as FT guarantees a "decent" price to the farmer in all circumstances. These objections can be summarized as follows in three arguments:
1. A fixed, guaranteed price, does not induce efficiency, cost savings and adaptations in the market. It maintains inefficient producers in the system when, in fact, they should stop production and leave it to the more efficient producers. This argument is sound, except that poor farmers in a poor country struggling for survival, with no access to modern technology, will always lose the battle for production efficiency\(^4\). Why should we apply western notions of efficiency and performance to people struggling to survive in their livelihood? Such farmers are usually poorly integrated in the marketing system, and typically markets are very imperfect\(^5\) in such circumstances. FT, in bypassing strict marketing criteria of efficiency and performance, can uplift such farmers and make the transition possible to more efficiency and better market performance. But the lesson is that FT must target the poorest of the poor farmers where social arguments (a decent livelihood) are much more important than purely economic criteria of production efficiency.

2. To the extent that FT is successful in guaranteeing higher prices to farmers, and in reaching many farmers, overproduction, which is the root cause of low producer prices, will persist and low producer prices will remain. Thus, those farmers that cannot sell at FT prices, will be really hurt and will be condemned to receive

\(^4\) Most farmers in developing countries produce efficiently with the resources and technology at hand, thus confirming T.W. Schultz (1964) thesis of "efficient, but poor". Only access to improved resources, including credit, and better production technology, will enable them to increase productivity and incomes and to escape "penny capitalism".

\(^5\) Imperfect markets are markets that lack the hardware and/or the software to function properly. In particular, physical infrastructure, rules, norms, regulation and market information are deficient and lead to poor performance.
forever low prices. In this sense, FT ensures permanent low market prices. This reasoning only holds when FT becomes a reasonable share of the total market and thus becomes "mainstream". This is still very hypothetical as FT coffee, the largest product in the FT market with 15,000 t per year (2001) makes up only 0.014% of the total coffee market of 110 million ton. But the lesson is that the FT segment cannot become mainstream.

3. FT is unfair with respect to the farmers that have to sell at normal market prices. FT usually targets small cooperatives or farmer's associations, and farmers that do not belong to these are in fact discriminated against. The same applies to private traders, plantations, and companies that have to compete with the FT traders. This argument is valid and therefore, FT needs to apply strict criteria in targeting the poorest farmers.

The conclusion from the foregoing is that FT can only be economically justified if:

- it targets really poor farmers (the "poorest of the poor");
- operates as a poverty alleviation instrument;
- does not become mainstream and thus remains a relatively small segment of the total trade;
- remains market conform and does not distort regular market channels.

The most important are the poverty targeting criteria and the concept of FT as an instrument of poverty alleviation. Secondly, it should not work against but rather work with the regular trade, wholesalers and retailers. Few if any economists will object to a poverty alleviation instrument in conformity with market principles. Unfortunately, the proponents of FT rarely advance these concepts and principles.
Their actions are often directed against the regular trade, multinationals and the private sector. Also, they often defend the idea that all of the trade with developing countries should become FT.

5. Market power and asymmetry in primary commodity markets

Large multinationals (e.g. in the coffee sector: Nestlé, Proctor and Gamble, Philip Morris, Sara Lee, Unilever, etc.) are often accused of maintaining low prices to farmers in developing countries, while in fact market imbalances - oversupply respective to demand - is the fundamental root cause of persistant low prices. One cannot accuse multinational companies of paying prices in conformity with market conditions. And in many instances, large multinationals in the field pay the best prices for higher quality as compared to small-scale independent traders (from personal experience).

The fundamental imbalance in primary agricultural commodity markets is one of market power, northern rich traders versus poor farmers, and particularly the asymmetry in market information. Buyers are usually much better informed about prevailing market conditions and prices, they hedge their operations on the primary commodity futures markets (thus eliminating price risk) and sell in a consumer market dominated by strong brands and customer loyalty. The oligopolistic position of large multinationals in consumer markets through branding allows them to consistently achieve strong profits and high returns on investment, whatever the prices paid to farmers. One cannot blame them for skilled consumer marketing and brand policy, thus escaping cutthroat competition with private labels and hard discounters (such as Aldi and Lidl in Belgium). Nevertheless, corporate governance dominated by the
three p's (people, profit, planet), upholding stakeholders interests and ethical business principles forces the big firms to go beyond what market forces dictate, and, for instance, to sell FT products alongside regular products. But they only do it because some of their stakeholders, including shareholders, public institutions and NGO's, force them to do so. Sometimes they do it just for window-dressing. And some large multinationals refuse to deal with FT products out of principle (Nestlé, Sara Lee).

In liberalized primary commodity markets, such as those for coffee, cocoa, cotton, it is very important that a performant market information system (MIS) is in place to provide poor farmers with up-to-date market information. Such information, distributed via the media on a daily basis, usually includes the prices paid in the external market, usually the London or New York futures market for primary commodities, and the prices paid to farmers in the local market by buyers. Such MIS now operate in most producing countries, but many suffer from poor financing, inadequate distribution of the information and too much donor dependency.

There is recent evidence that supermarkets benefit unduly from FT products and take their cut of FT products. The Sunday Times (UK, June 29, 2003) reported that some of Britain's biggest supermarkets have been accused of exploiting customers' goodwill by overcharging for FT products. This is easy as the items will always be more expensive than their ordinary equivalents because of the FT scheme. As the price for FT products can be double that of the ordinary equivalents, there is room for generous profits. Sainsbury, Tesco and Asda were all doing it. FLO does not have control over the final price of the product, and this constitutes a loophole that supermarkets are exploiting. They point out that the scheme is still benefiting poor farmers - never
mind that they benefit even more - and that there are more costs associated with stocking and distributing FT products.

6. Conclusions

FT is superior to development aid. But demand for FT products in the North is a major constraining factor. Unfortunately, most of the FT products are generic agricultural products with no brand recognition, where cutthroat price competition by hard discounters is common. It is hoped that the common FT logo that has been introduced will induce buying loyalty and will increase volume of trade.

FT should be seen as an instrument of poverty alleviation and there must be strict criteria for the targeting of the "poorest of the poor". Unfortunately, many FT protagonists do not see it that way and want FT to scale up to mainstream, moving away from the niche towards the mass consumption\(^6\). In my view, this is an error. If that would happen, FT will fail by its own success, as analyzed in this paper. The poverty targeting criteria of FT products should be made explicit. Obviously, there is no need for targeting in countries like Tanzania, Rwanda or R.D. Congo. But one cannot say the same of FT products from Brazil, Colombia or Costa Rica.

Economists are generally skeptical of schemes that try to "manage" the market - excluding the invisible hand in demand and supply, as is for instance the case in the European Common Agricultural Policy, at great costs to European taxpayers. Also, if

the large multinationals that presently refuse to include FT products in their product range were explained the concept of FT as a targeted poverty alleviation instrument, and not as an instrument to "circumvent market balance between demand and supply"\(^7\), then chances for their adhesion would be much better. Many economists are convinced (rightly) that market balance in the long run offers the best possibility for smallholders producers in the developing world. But this implies supply management "OPEC style" or controls on the expansion of production. One should not forget that the persistant low coffee prices over the last five years are mainly the result of Vietnam's enormous expansion of low grade Robusta coffee production, from less than 100,000 t/year fifteen years ago to more than one million tons now. Supply management in poor developing countries in a coordinated way is extremely difficult to achieve, and is the main reason why all international commodity agreements have been abolished.

\(^7\) Statement by Jacobs Café of Germany, reported in FLO Fairtrade Forum Number 5, November 2001.
Bibliography


du TOIT, Andries (October 2001). Ethical Trading - A Force for Improvement, or Corporate Whitewash. ODI. Natural Resources Perspectives, Number 71.


I thank Geert Provoost for assistance.


List of Available Working Papers


nr. 70 TOLLENS, E., and DEMONT, M., *Biotech in Developing Countries: From a Gene Revolution to a Doubly Green Revolution?*, Department of Agricultural and Environmental Economics, Katholieke Universiteit Leuven, November 2002, 8 p.


