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Cost and Benefit Analysis of Fair Trade

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Abstract

Fair trade endeavours to provide higher level of finance for producers, sustainable long term buyer seller relationship, formation of effective producer organizations, improve community development and promote environmental friendly production methods. The fair trade process started with coffee. As a result, Coffee still has the highest share of quantity among all fair trade products in the market with highest number of involved producers and workers providing the guaranteed minimum price for coffee sold under fair trade label is supposed to reduce financial risk of farmers and provide better living standard for their workers. However, obtaining fair trade certificates are not free of charge from 2004 as producer should pay for application, initial certificate and also renewal of certificate. Payment of such fees can take away a substantial part of premium received by farmers. Other problem to notice is that fair trade buyers do not guarantee the procurement of whole production of certified producers. As a result, farmers will face a dilemma of whether or not to apply for fair trade certifications or continue renewal of their certificates. In other words, cost and benefits of receiving fair trade certificate is not completely clear for many producers. In its endeavour to tackle above mentioned problem, this paper will take a comparative approach to existing research materials on coffee production under FLC in Latin America to find answer to the question of what are costs and benefits of being a certified fair trade coffee producer?

Paper is divided into four main parts. After the introductory part, economics of fair trade certificates will be reviewed. Third part will provide analysis on cost and benefits of receiving fair trade certificate and last but not the least, fourth part will provide conclusive remarks on the discussion.

Keywords: fair trade, economy, development, cost benefit analysis, coffee.

1. Introduction

In today's life, it is common experience to face with fair trade products on the daily basis. A great number of products are distributed in global market carrying fair trade labels and promote idea of movement which in one hand provides standard products for consumers and on the other hand improves living standards of disadvantaged producers in underdeveloped societies. In doing so, fair trade endeavours to provide higher level of finance for producers, sustainable long term buyer seller relationship, formation of effective producer organizations, improve community development and promote environmental friendly production methods.* The fundamental idea behind fair trade is a certification system which requires all members of value chain to meet standards that are set in order to achieve above mentioned objectives. The fair trade label on product is sign of meeting standards by producer and informs the customer about social and environmental responsible production process of goods.

The fair trade process started with coffee.†As a result, Coffee still has the highest share of quantity among all fair trade products in the market with highest number of involved producers

* Dragusanu, R., Giovannucci, D., & Nunn, N. (2014). The economics of fair trade. *The Journal of Economic Perspectives*, 28(3), 217-236.

† Ibid

and workers.* After emergence of early initiatives of Fair Trade in the Netherland during late 1980's, idea of providing sufficient wages for coffee growers received warm welcome all around developed countries. In 1997, an umbrella organization was formed by national labelling initiatives under the title of Fair Trade Labelling Organization International (FLO). The Common Fair Trade Certification Mark was introduced respectively in 2002.†Currently, the organization is active in 132 countries.‡

As mentioned earlier, main objective of Fair Trade Certification is improving living standard of disadvantaged farmers and workers in developing and under developed nations. Therefore, Fair Trade Certificates pursue their objective in the format of particular requirements including:

- Prices: products would receive a guaranteed minimum price in addition to fair trade premium which are set separately for each product.

- Employees: While child labour is prohibited, employees enjoy the right of freedom of association, safety at work, and at least minimum legal wages.

- Institutional Structure: Farmers are obliged to make cooperatives where decision making process will be more democratic. Also, administration process should be transparent under jointly formed committees of workers and farmers.

- Environment: It is prohibited for certified cooperatives to use certain harmful chemicals. However, they are encouraged to agrochemicals with biological methods. They are supposed to provide environmental reports with summary of their impact on the environment.

- Access to credit: Upon receiving fair trade certificate by farmers, buyers will provide them with long term contract and advance finance (up to 60 % of production price).

Providing the guaranteed minimum price for coffee sold under fair trade label is supposed to reduce financial risk of farmers and provide better living standard for their workers. However, obtaining fair trade certificates are not free of charge from 2004 as producer should pay for application, initial certificate and also renewal of certificate. § Payment of such fees can take away a substantial part of premium received by farmers**. Other problem to notice is that fair trade buyers do not guarantee the procurement of whole production of certified producers††. As a result, farmers will face a dilemma of whether or not to apply for fair trade certifications or continue renewal of their certificates. In other words, cost and benefits of receiving fair trade certificate is not completely clear for many producers. In its endeavour to tackle above mentioned problem, this paper will take a comparative approach to existing research materials on coffee production under FLC in Latin America to find answer to the question of what are costs and benefits of being a certified fair trade coffee producer?

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2. Results

Economics of Fair Trade Certification

A market has its equilibrium where the supply equals the demand. The lowest legal price a commodity can be sold at is called the price floor. In order to have an effective price floor, it must be set above the equilibrium price, otherwise it would be irrelevant since the market would not sell below the equilibrium price. The guarantee price (price floor) prevents the prices from being too

* Fairtrade International (2012). Monitoring the Scope and Benefits of Fair Trade, Fourth Edition, 2012, Mimeo.

† Website of Fair Trade Organization, <http://www.fairtrade.net/> [visited on 20 November 2016]

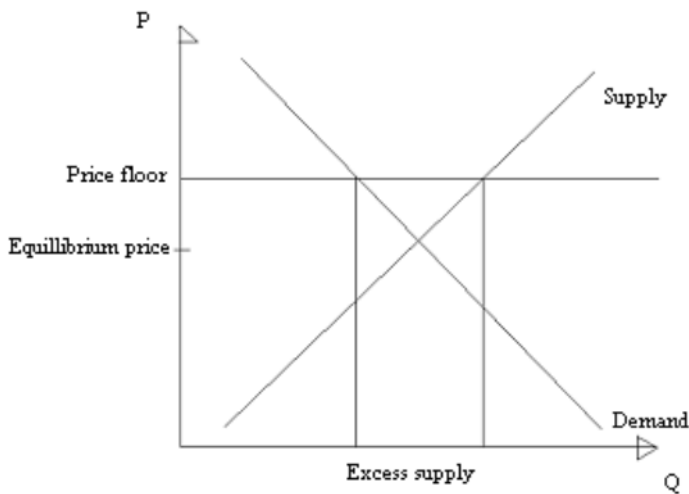
‡ Ibid

§ According to FLO-CERT (2011). The current initial certification fee for an organization with less than 50 members is 1,430 Euros and the annual certification fee is 1,170 Euros. Producers also pay the administrative costs of a Follow Up Audit if one is required. The cost of this is 350 Euros per day plus travel costs.

** Saenz-Segura, Fernando and Guillermo Zuniga-Arias (2009). Assessment of the Effect of Fair Trade on Smallholder Producers in Costa Rica: A Comparative Study in the Coffee Sector. Ruerd Ruben (ed), The Impact of Fair Trade, pp. 117-135. Wageningen: Wageningen Academic Publishers.

†† Dragusanu, R., Giovannucci, D., & Nunn, N. (2014), 10.

low, and farmers from changing crops in the field when the world market prices are fluctuating. Paying the guarantee price leads to a rising in the average price for coffee, and might encourage more producers to enter the coffee market.



Providing credible information to customer is a fundamental rational in Fair Trade practice. In some areas of the globe, customers are ready to pay higher price for product characteristics like applying environmental friendly method of production, not using child labour, and access to fair wage to producers and workers. Fair Trade Certificate is in fact providing a credible link between customers who are ready to pay more for products with above mentioned characteristics and producers ready to produce them. Therefore, Fair Trade Certificates increase market efficiency by creating market for products which could not be sold without their existence. Study of Podhorsky on environmental standards showed existence of voluntary certificate program for heterogeneous firms with no production externality will not reduce the customer welfare*. She showed that income rise is the main factor for firms to apply environmental standards in their production process. On the customer's side, despite the fact of bearing higher prices, they would be better off due to access to greater product variety.† However, this will raise the question whether or not customers really care about social and environmental friendly method of production in fair trade products. Some studies have approached the question of how much customers are really willing to pay for fair trade products. A survey of 258 individuals showed that 75 % of coffee buyers are eager to pay 15 % more for coffee with fair trade certification‡. In a more recent study, in 26 American stores, surveyors placed fair trade labels on certified coffee bins in a random fashion. Later, they also varied the price of coffee.§ Both situations resulted strong evidence showing higher demand for Fair Trade Coffee. Findings showed certified fair trade coffee sold 10 % more than other types where customers did not show price sensitivity to its higher price.** A logical conclusion would be two folded: first, consumers in developed countries value ethical products. Second, "fair trade labels convey credible information.††

Apart from cross sectional methods experimented in examining economic function of Fair Trade Certificates, other methods used like matching methods and panel studies show same result.**

* Podhorsky, Andrea (2010). Environmental Labeling. Mimeo, York University.

† Podhorsky, Andrea (2013). Certification Programs and North-South Trade. Mimeo, York University

‡ Hertel, Shareen, Lyle Scruggs, and C. Patrick Heidkamp (2009). Human Rights and Public Opinion: From Attitudes to Action. *Political Science Quarterly*, 124 (3): 443-459.

§ Hainmueller, Jens, Michael J. Hiscox, and Sandra Sequeira (2011). Consumer Demand for the Fair Trade Label: Evidence from a Field Experiment. Mimeo, Harvard University.

** Ibid

†† Dragusanu, R., Giovannucci, D., & Nunn, N. (2014). P. 14

** Beuchelt, Tina D. and Manfred Zeller (2011). Profits and Poverty: Certification's Troubled Link for Nicaragua's Organic and Fair Trade Coffee Producers. *Ecological Economics*, 70: 1316-1324; Dragusanu,

Cost Benefit Analysis of the Fair Trade

Although, in theory the rationale behind Fair Trade is a description of win-win situation where both for buyers will be better off. But, for how long earning of benefit will continue? In another words, existing possibility for all producers to enter into free trade certification system will fade away the benefit of membership in some point. Number of certified producers will be increased up to the point that cost and income of being a certified Fair Trade coffee producer will become equal. De Janvry *et al* developed the model in which they analysed effect of free entry of producers in the Free Trade System and at the end concluded that free entry can result in death of the system.* However, greater entry level should not be approached only as a negative factor. Even if all financial benefits of membership in fair trade system fades way due to saturation of market with certified producers, still producer society is on the winning side. Higher number of certified producers means better working condition, more environmental friendly production systems in place, more long term business relations and more access to financial support for producers.

Effects of certificate on living condition of producers

As it mentioned before, foremost objective of Fair Trade is to improve the living standard of producers in developing and underdeveloped countries. Different mechanisms used in achieving this goal include: higher payments to farmers in order to create further financial stability, creation of long term relations between buyers and sellers, providing more facilitated access to credit for farmers, and finally offering a price floor which guarantees the minimum price offered to producers. While producers consider advanced credit as the most important advantage of fair trade (followed by price floor), some serious concerns question the effectivity of the plan. Studies of Reynolds on Fair Trade Certified producers in Peru and Mexico showed that main stream (bulk) buyers like Nestle, Starbucks and Costco are not interested in providing advance credit to producers. Generally, they sign a one year contract as required by FLO but, no other step will be taken towards creation of long term relation.† However, other studies do not support findings of Reynolds.‡

Second important factor in function of Fair Trade System is the introduction of Fair Trade price floor which provides safety net to producers in occasion of significant price fall in global market. Despite the fact that price floor guarantees selling the coffee in a predefined price, it is not possible for farmers to sell all licensed capacity with price floor set by Fair Trade buyers. Mendes *et al*, showed that in average about 60 percent of crop produced by certified producers is sold to fair trade buyers§. Other studies show that in global reduction of coffee price, sales rate to fair trade buyers would reduce.**Researchers claim that such reduction in amount of sales is due to free entry factor, but it is still unclear as drop might be result of increasing interest in buying more conventional coffee (which has lower price).

In conclusion, despite the fact that price floor is set to provide stability, licenced producers still face with risk of change in sales amount under fair trade system.

Environmental Impacts of Certification

Researchers have tried to identify effects of Fair Trade System on environment. Studies in Mexico show strong inclination of Licenced producers towards environmental friendly methods of

Raluca, and Nathan Nunn. 2013. The Impact of Fair Trade Certification: Evidence from Coffee Producers in Costa Rica. Mimeo, Harvard University

* De Janvry, Alain, Craig McIntosh, and Elisabeth Sadoulet (2012). Fair Trade and Free Entry: Can a Disequilibrium Market Serve as a Development Tool? Mimeo, University of California, Berkeley

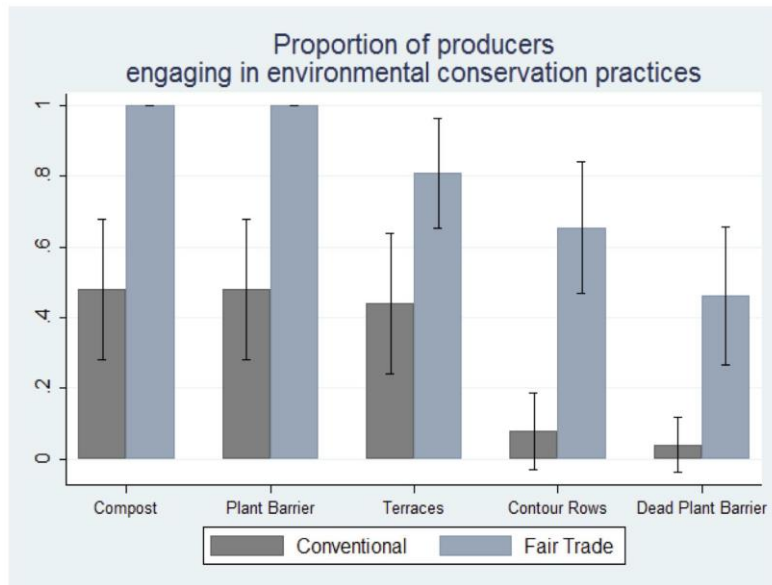
† Reynolds, Laura T., Douglas Murray, and Andrew Heller (2007). Regulating Sustainability in the Coffee Sector: A Comparative Analysis of Third-Party Environmental and Social Certification Initiatives. *Agriculture and Human Values*, 24: 147-163.

‡ Mendez, V. Ernesto, Christopher M. Bacon, Meryl Olson, Seth Petchers, Doribelm Herrador, Cecilia Carranza, Laura Trujillo, Carlos Guadarrama-Zugasti, Antonio Coron, and Angel Mendoza (2010). Effects of Fair Trade and Organic Certifications on Small-Scale Coffee Farmer Households in Central America and Mexico. *Renewable Agriculture and Food Systems*, 25(3): 236-251; Bacon, Christopher M, V. Ernesto Mendez, Maria Eugenia Flores Gomez, Douglas Stuart, and Sandro Raul Diaz Flores (2008). Are Sustainable Coffee Certifications Enough to Secure Farmer Livelihoods? The Millennium Development Goals and Nicaragua's Fair Trade Cooperatives. *Globalizations*, 5 (2): 259-274.

§ Mendez *et al* (2010)

** de Janvry, Alain, Craig McIntosh, and Elisabeth Sadoulet (2012)

production in comparison with conventional producers.* Figure below illustrate the proportion of licenced producers in comparison with conventional producers in applying environmental friendly production techniques†.



Another study on 177 framers in Nicaragua shows that Fair Trade Licenced Farmers are much more environmental friendly than conventional farmers. *Where 68 % of licenced farmer were using ecological water purification systems, same methods were used by 40 % of conventional producers. §

In conclusion it is possible to mention that existing studies evidence success of Fair Trade in promotion of environmental friendly and sustainable development methods of production among licensed farmers.

Distribution of wealth in Fair Trade System

In general, farmers and their employees are counted together as beneficiaries of Fair Trade. However, distribution of profits between framers and hired workers is a very important issue in cost benefit analysis of fair trade system. The coffee industry is formed by small family size farms which hire seasonal workers which makes evidence collection of distribution of benefit among beneficiaries difficult. However, existing studies also shed light on this aspect of cost benefit analysis in Fair Trade system.

In an study of coffee growers in Nicaragua, resulted that despite payment of premium to all licenced coffee growing farms, no worker received either extra payment to customary minimum wage rate or any form of social benefit**. Other study in Costa Rica on the sample of 110000 workers from 2003 to 2010 reached the result that despite receiving higher payment by licenced farms , regular workers have not benefited from it at all. †† Also studies in Mexico show that only a portion of benefit of Fair Trade received by farm has been passed to regular workers.**

* Jaffee, Daniel (2009). Better, but not Great: The Social and Environmental Benefits and Limitations of Fair Trade for Indigenous Coffee Producers in Oaxaca, Mexico. Ruerd Ruben (ed), The Impact of Fair Trade, pp. 195-222. Wageningen: Wageningen Academic Publishers

† Differences in environmental practices between Fair Trade and conventional coffee producers in Oaxaca, Mexico. Averages (and 95 % confidence intervals) are reported for 25 Fair Trade farms and 26 conventional farms. Jaffee (2009), Chapter 9, Table 6.

§ Bacon, Christopher M, V. Ernesto Mendez, Maria Eugenia Flores Gomez, Douglas Stuart, and Sandro Raul Diaz Flores (2008). Are Sustainable Coffee Certifications Enough to Secure Farmer Livelihoods? The Millennium Development Goals and Nicaragua's Fair Trade Cooperatives. *Globalizations*, 5 (2): 259-274.

§ Ibid

** Valkila, Jon and Anja Nygren (2009). Impacts of Fair Trade Certification on Coffee Farmers, Cooperatives, and Labourers in Nicaragua. *Agriculture and Human Values*, 27(3): 321-333.

†† Dragusanu, Raluca, and Nathan Nunn (2013)

** Jaffee (2009)

Another concern is regarding distribution of Fair Trade benefits among farmers in a cooperative. Despite the fact that empirical evidence on distribution methods used by farmers are limited but , some studies show instances of tension among farmers in fair trade certified cooperatives.* Evidences show concerns of cooperative members about performance of leaders in four Latin American countries.† In another study in Costa Rica, researcher defined a significant mistrust between members of cooperative due to past managerial problem. ‡A study of 180 Fair Trade Certified coffee farmers in Peru revealed that 12 % of farmers have no idea about existence of premium payment and 77 % explained their concern about not receiving Fair Trade benefits.§ Above mentioned concerns are confirmed by evidences taken from Fair Trade farms from Africa.**

3. Conclusion

In this paper, author tried to compare and contrast costs and benefits of Fair Trade System applied to coffee farmers in Latin America based on existing empirical data available from scientific research on the subject matter. In conclusion, it is possible to say that empirical evidence shows that Fair Trade has achieved many of its objectives on supply and demand side of the market. Fair Trade Certificates provide reliable source of information for purchasers while producers enjoy extra premiums, available finance and other benefits of Fair Trade system. However, there are still ambiguities regarding the way system should function. Such ambiguities are particularly attributed to methods of dividing finances among beneficiaries to the system.

Despite existence of such ambiguities, still Fair Trade seems to be more beneficial method for promoting sustainable development in disadvantaged countries rather than direct transfer of money. Fair Trade is strongly recommended due to benefits it bring about including increasing motivation of producers, rewarding productive activities, improve environment and society as well as welfare of customers.

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* Mendez et al., 2010.

† Ibid

‡ Saenz-Segura, Fernando and Guillermo Zuniga-Arias (2009). Assessment of the Effect of Fair Trade on Smallholder Producers in Costa Rica: A Comparative Study in the Coffee Sector, Ruerd Ruben (ed), *The Impact of Fair Trade*, pp. 117-135. Wageningen: Wageningen Academic Publishers.

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