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# On the efficiency of fair trade

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## Abstract

This paper uses competitive equilibrium theory to analyze the economic efficiency of international "fair trade" between ethical consumers and low-income producers. The main an sion in a state of d, not leisure, obinson's theory o rganization", which ha monopsony rents. A e, and in a state llocation. The con tion for labor, ar tened trade liberaliz

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## Acknowledgements

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# Notes

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

The app ears reasonal e an appropri l by fair trade, a nder oligo cts heteroge our) under involunt t from clearing

2 It shou etitive equilibrium coordinate ($n_2$, $w_2$) does not correspond to the Pareto optimum, which

may be represented instead by the coordinate ($n_3$, $w_3$), 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.

3 This result does not appear to require the assumption of efficient rationing in the sense of Becchetti and Adriani (2002), that the local fair trade organisation must employ the workers with the lowest reservation wages.

4 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 disequili concept of long-per sted capacity equisite futures m gument does not economic theory) t period cost of pr

5 The co l fair trade organiza oes not represer

6 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.

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