Master thesis for the Master of Economic Theory and Econometrics degree

Fairtrade, fair consumers and public policy

Asmund Rygh

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Department of Economics

University of Oslo

Abstract

This thesis looks at the implications for public policy of the existence of ethical consumers and altruistic agents like Fairtrade. It is argued that there are market failures in the provision of "fair" goods, which may justify public policy. Of such market failures, the most important seems to be in the provision of ethical information about the goods. Searching and summarizing such information to make it useful for ethical consumption might mean large costs, but when this information is first produced and summarized in an ethical product label on goods, it makes ethical consumption easy for the consumer. Therefore ethical information seems to have the characteristics of a public good. The need for public intervention is reduced by the existence of altruistic agents like Fairtrade, who certify fair products and label them for the consumers. However, such labelling has so far mainly concerned simple products, often primary products like coffee. Labelling products with a more complex and less transparent production chain may require more resources, and therefore public support.

I set up a partial equilibrium model to study the implications of different public policies. One type of public policy aims to facilitate ethical consumption by providing consumers with information and/or an alternative. Another type of public policy, regulation, goes further and removes the option of "unfair" goods. This could be done e.g. through international standards for labour and the environment. Providing consumers with information may have predominantly negative welfare effects if there is no fair alternative. On the other hand, requiring fair production may be harmful if consumer fairness is low, or consumers are not informed. Ethical consumption might therefore be harmful without ethical production, and vice versa. Ensuring a fair alternative to consumers, like Fairtrade does, seems both to offer most of the positive effects, while minimizing potential negative effects. However, to the extent that it is too costly for agents like Fairtrade to label some types of products, public policy may be needed to ensure a fair alternative.

Preface

Supervisor at the Department of Economics at the University of Oslo was Professor Jon Vislie. Co-supervisor at the Norwegian Institute for Consumer Research was Arne Dulsrud. I would like to thank both for countless valuable comments and suggestions as well as stimulating discussions, that helped me define the topic of this thesis, and greatly improved the result.

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It was inspiring for me that many people around me found the topic of this thesis engaging. I would like to thank all who have given comments and discussed it with me. These include friends and family, and fellow economics students. A special thanks to Anna Milford for many valuable comments. Also thanks to participants at the NORAD seminars in 2006 on trade with developing countries for interesting discussions.

Of course, remaining errors and weaknesses are my responsibility.

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1 Introduction[1]

Fairtrade means among other things that farmers from poor countries receive a guaranteed minimum price for their produce, or that workers receive a minimum wage, that they have good working conditions, and that production is environmentally-friendly. In exchange, consumers in the developed countries agree to pay a higher price in the shops. Fairtrade came about because many people thought that conventional trade was unfair and did not benefit the poor in the South. Small coffee farmers, for example, have for a long time had a difficult situation with low and fluctuating coffee prices.[2] To help them, some consumers want to pay a little extra for “fair” coffee.

Fairtrade is now one of the fastest growing markets in the world, with over 20 percent increased sales annually since 2000.[3] The Fairtrade market share has also become significant for some products. In Switzerland, for example, 47 percent of all bananas are labelled Fairtrade, and in the UK 20 percent of the ground coffee is fair. Also in Norway Fairtrade is growing fast, with sales increasing with 28 percent from 2003 to 2004. Still, however, only 1.5 percent of the coffee sold in Norway is Fairtrade.

In general, “fair” products make up a very small share of total trade between the North and the South, and for many products there exists no fair alternative. The starting point for this thesis was a thought experiment of an agreement with the principles of Fairtrade applied to all products from the South. Many people wish to see the gains from trade and globalization divided more equally, and to ensure that the gains reach everybody. However, it is also often argued that countries in the South cannot afford what we see as decent wages and working conditions and protection of the environment, and that we have to wait until they have achieved a higher income level.[4] Fairtrade could be seen as an answer to this. By paying a higher price for products from the South, in exchange for a guarantee that basic standards for work and the environment are respected, consumers in the North could help the South achieve faster development.[5]

This presupposes that consumers are willing to pay extra for the costs of ensuring decent working conditions in the South. The reason that so little of world trade is Fairtrade could be that most consumers do not in fact have the willingness to pay. However, to

[1] This chapter contains some material from Rygh (2006).
[2] See section 2.1.
[3] The figures are from Fairtrade Advocacy Office (2005:5-7 and 57).
[4] See Snoen (2004), Henderson (2001), Hoekman and Kostecki (2001) and Lomborg (2001).
[5] See also Rygh (2005).

conclude in this way, we have to suppose that the markets are well-functioning in the sense that consumers' preferences for Fairtrade are accommodated. Alternative explanations of the low share of Fairtrade are *market failures in the provision of fair goods*, of which the most important seems to be information about the ethical characteristics of goods. The general argument is as follows. When a consumer considers buying a product from the South, he or she does not know whether the product has not been produced using child labour, with bad working conditions and subsistence wages, or large environmental problems. This can lead the consumer to feel *ethical risk*.

To reduce ethical risk, the consumer can either search ethical information about the good, or buy a good that he or she considers ethically "safe". The consumer may for instance trust that products in the North have been produced in a fair manner because of legislation. As for ethical information, there exist many sources, like specialized ethical consumer magazines, and a large number of internet sites. However, there may be high costs associated with finding and making use of such information for ethical consumption. For all except the most concerned consumers, these costs might be near prohibitive. In some cases, information may also simply be unavailable.

On the other hand, if the relevant ethical information could be summarized in a simple "ethical" product label, it would be costlessly available to all consumers, and make ethical consumption easier. I therefore argue that ethical information has the main characteristic of a *public good*: There are large fixed costs in searching and summarizing information, but when this is first done, the costs of allowing an additional consumer access to this information are negligible. Free-rider problems then mean that we could then have a too low supply of ethical information in a private market, which means that there might be a role for public policy.

However, an important objection against the need of public involvement is exactly that there have been established private labelling schemes like Fairtrade, that guarantee consumers a fair alternative. These altruistic agents are willing to incur the costs associated with fair labelling, and thus help correct the market failure in ethical information. Does this mean that public policy after all is unnecessary?

Here the fact that Fairtrade labelling currently exists only for certain products, mostly primary products like coffee, could be of importance. One possible explanation for this fact might be that certain characteristics of primary products make producers especially vulnerable. For example, supply and demand conditions may make the income from agricultural production highly volatile. One could therefore argue that there is less need for

Fairtrade in other products. However, also in other industries like the textile industry and even the production of mobile phones there have been many reports of bad working conditions.

To me, a more plausible explanation for the fact that there is Fairtrade in some products, but not others, is that there are differences between products in how easy it is to verify that production is fair. It is probably easier to ensure fair production of a “simple” product like coffee, than of products that have a longer and more complex production chain. To the extent that labelling other products requires more resources, it is therefore possible that it will be too costly for private altruistic agents like Fairtrade.

As for public policy, there are several options available. One strategy could be to label all products from the South, so that consumers can choose between fair and unfair products. However, there may not always be a fair alternative available. A second possibility is to ensure that consumers have the option of a fair good. These two strategies imply public intervention through helping consumers in their ethical consumption.

But many are sceptical of what ethical consumption can achieve in addressing the problems of globalisation, and instead call for international legislation, e.g. through standards for labour and the environment in the World Trade Organization (WTO).[6] However, developing countries oppose such standards, fearing they will work as hidden protectionism from the North countries, and mean reduced competitiveness.[7] If standards lead to reduced trade, they could have negative effects for the South. On the other hand, if fair North consumers are willing to pay for the costs of fulfilling standards, trade need not be reduced.

In this thesis, I set up a partial equilibrium model to study the welfare implications of different public policies, and the relationship between them. The aim is to arrive at broad policy suggestions. In addition, I hope the work can help identify important topics for future research.

The structure of the thesis is as follows. In *chapter 2*, I present Fairtrade in more detail, and discuss some previous economic literature on Fairtrade. The literature has so far mainly focused on the production side. Some of this literature points out how fair trade can address specific market failures. The critical literature claims instead that Fairtrade by introducing distortions in the market has unintended and harmful side-effects. An evaluation of some of these arguments requires a closer look at the consumer side in Fairtrade. This is done in *chapter 3*. I start with placing Fairtrade in the broader context of ethical consumption, and related phenomena like ethical investment and corporate social responsibility. While most

[6] Among them are the current Norwegian government (*Ny Tid* nr. 47, 1.-7. desember 2006, p. 55).
[7] Hoekman and Kostecki (2001), Bourguinat (2005), Eriksen and Tretvoll (2006).

economic theory is based on self-interested agents, with Fairtrade it seems obvious that one must include preferences for other agents. As a preparation for the analysis, I discuss how consumers' preferences for Fairtrade should be modelled, drawing on economic theory on social preferences. The choice of modelling strategy is shown to have important implications for the results of the analysis.

In *Chapter 4*, I present in more detail the argument that ethical labelling is a public good, and discuss some objections. I also discuss some other costs for the consumer of ethical consumption, besides searching ethical information. In *chapter 5*, I set up a model to study the welfare effects of different public policies in the North and the South. The model incorporates ethical risk over a good from the South, and assumes that ethical labelling is the consumers' only source of ethical information, i.e. that the costs of searching ethical information are prohibitive. The effects of the different public policies will be shown to depend on the assumptions made about consumers' preferences, information, and their beliefs about the fairness of production in developing countries, as well as on the reactions of South firms. I conclude chapter 5 by giving an overview of more fine-tuned policy alternatives. In *chapter 6* I sum up the main results, discuss some reservations to the analysis, and give suggestions for future research.

2 About Fairtrade

In chapter 2, I describe Fairtrade more closely. Fairtrade arose because consumers wanted to help producers and workers in the South who experience problems. In section 2.1 I describe some of these problems. A brief historical overview of Fairtrade is given in section 2.2, and a closer presentation of the Fairtrade system and standards in section 2.3. However, the emphasis in this thesis will not be on details about the Fairtrade system, but rather on the general idea of Fairtrade.

Fairtrade presupposes a theory of justice. Some possible theories are discussed in section 2.4, with weight on a just distribution from the gains from trade. This means that there will also be a brief discussion of the gains from trade for developing countries. In section 2.5, I present some of the existing economic literature on Fairtrade.

2.1 The problems facing many workers and producers in the South

The situation of many coffee producers is described by Milford (2004:1). The coffee producers are based in rural areas where the infrastructure is poor and the level of service provision is low. They have an insecure income because of fluctuating international coffee prices. For many years, coffee prices showed a downward trend, reaching a record low in 2001. In the last couple of years, coffee prices have started to increase, but it will be some time before poor coffee producers gain from this.[8] Milford further argues that local purchasing markets for coffee are often characterised by imperfect competition, and that the lack of information and infrastructure make the farmers vulnerable to market failures such as cartels. Studies of the value chain for coffee have showed that only a small portion of what the consumer pays for coffee accrues to the producer, and this portion is getting smaller. Milford cites a recent study which showed that coffee farmers today receive only around 6 percent of the value of a pack of coffee sold in a store.[9] There are also great problems in the production of many other primary products, like bananas and cocoa.[10]

Recently, Western consumers have become concerned about the conditions for workers in factories in developing countries. So-called *sweatshops* have often been revealed

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[8] *Aftenposten*, morgen, 23.08.2006, Økonomi, p. 6.
[9] Milford (2004:7).
[10] See e.g. Ransom (2001).

in connection with the activities of transnational companies, and were brought to consumers' attention by among others Klein (2000).[11] For most of the products produced here there exists no Fairtrade alternative.

2.2 The history of Fairtrade

"Fair trade" as an idea is at least 50 years old, when community and church organizations in Europe and North America started buying products from other community organizations in the developing countries (Fairtrade Labelling Organizations International (FLO) 2006c:2). Milford (2004:8) writes that in the 1960s, Fairtrade came up as a response to developing countries' dissatisfaction with their terms of trade. Alternative Trading Organizations (ATOs) started selling products from developing countries directly to concerned consumers in the North through "alternative" markets, where the producers were paid above the market price. The ATOs were typically responsible both for the importing, the distribution and the sale of the products, often in specialized "world shops".

The first Fairtrade label, with the name Max Havelaar, was created in the Netherlands in 1988. It was the result of a request from a Mexican cooperative of coffee producers who wanted help to market their product in Europe (Renard 2003). Today's Fairtrade labelling schemes, instead of using their own distributive networks, use the conventional networks, and Fairtrade products have also moved into traditional shops and supermarkets. Any commercial company can buy products from producers in the South and have its products Fairtrade certified, and sell them in the supermarket with a "Fairtrade" label. Compared to the old ATO system, this means lower costs and allows Fairtrade products to reach a much larger number of consumers than before (FLO 2006c:2, Milford 2004:8).

2.3 The Fairtrade system and the standards[12]

For a product to be Fairtrade certified, it must fulfil a number of standards. All buyers of the products have to pay the Fairtrade minimum price and/or a Fairtrade premium to the producers. The minimum price is meant to cover the costs of sustainable production. There is a Fairtrade premium when the world market price exceeds this price, which the producers and

[11] This does not however imply that conditions in poor countries would have been better without transnational companies. Rather, conditions in poor countries have become more visible to Western consumers through economic integration and the activities of companies with well-known brands. See Becchetti and Rosati (2005) and Engler (2006). As Gaarder (2004:74) points out, sweatshops are not limited to developing countries, but are found also in some developed countries.

[12] The information in this section is taken from FLO (2006b, 2006c).

workers are meant to use in improving their situation. Producers may also ask for pre-financing.

The standards are set by Fairtrade Labelling Organizations International (FLO). FLO was established in 1997 and is an association of currently 21 different National labelling initiatives.[13] FLO does not trade itself, but only certifies products. FLO researches and sets the Fairtrade Standard, the Fairtrade minimum price and the Fairtrade premium. The certification of the producers and the supply chains is carried out by the independent commercial company FLO-Cert. FLO and FLO-Cert are based in Germany. They only work with producer organizations and workers in developing countries. National Initiatives license the international Fairtrade Mark to use on products which respect Fairtrade standards and which are sold in their country. They also work to spread the understanding of Fairtrade and issues in international trade, and encourage customers to buy Fairtrade products. Most National Initiatives are based in developed countries, but recently some countries in the South have also established National Inititatives.

Different products have different standards, which reflects the fact the problems that producers and workers in developing countries experience are different from product to product.[14] For example, most of the coffee and cocoa is grown by independent small farmers, who work on their own land and market their produce through a local co-operative. For these producers, receiving a minimum price for their beans is the most important aspect of Fairtrade. On the other hand, most tea, for example, is grown on estates. For workers employed on tea plantations, the most important concern is fair wages and decent working conditions. There are therefore two sets of Fairtrade Generic Standards, one for small farmers and one for hired labour situations. FLO’s (2006e) introduction to these standards is given in appendix A. I will however not enter into detail about the Fairtrade standards, but discuss the idea of Fairtrade more generally.

2.4 Fairtrade and a just distribution of the gains from trade

In this section I discuss briefly the moral-philosophical ideas behind Fairtrade. The concept of fair trade implies on the one hand what most economists agree on, namely that trade is beneficial. On the other hand, Fairtrade also implies some criteria for how trade should be conducted, and how the gains should be distributed. A first perspective is the distribution of the gains from trade between countries. Even though trade leads to net gains, it is possible that

[13] Among them is the Norwegian *Fairtrade Max Havelaar*.
[14] See FLO (2006e).

North uses its economic muscle to take the lion's share of these gains. Further, when economists talk about the gains from trade, they are not saying that nobody will lose from trade. Trade might lead to net gains for a developing country as a whole, while some people in the country are worse off. The winners could then in theory compensate the losers, and everybody would be better off.[15] However, in practice such compensation often does not happen. Even if trade means an improvement for them, the gain of poor producers might be marginal. An important aim of Fairtrade is to allow poor producers to keep more of the gains themselves.[16]

The gains from trade for a developing country are discussed by Appleyard, Field and Cobb (2006:411-2). Trade theory says that if there is a difference between the domestic relative prices in autarky and the relative prices internationally, a country can increase its welfare by specializing in and exporting the relatively less expensive domestic good and importing the goods that are relatively more expensive. There will be a relative expansion of the sector(s) using relatively intensively the abundant factor. In the case of most developing countries, there will be increased incentives to expand labour-intensive production rather than modern, capital-intensive production. This means expanding agriculture, primary goods and labour-intensive manufactured goods. International trade therefore increases employment and puts upward pressure on wages, as in the Heckscher-Ohlin model. Even if the economy is not able to specialize right away, it will still enjoy the increased consumption possibilities made possible by trade.

Appleyard, Field and Cobb (2006:412) mention some reasons why in practice the static gains from specialization for developing countries might be limited. First, if there is high unemployment, as is usually the case in developing countries, the effect of increased demand for labour on the wage level might be limited. In addition, the lower income and price elasticities of such products, and in particular the instable supply of agricultural products due to factors like the weather, a greater specialization in these goods can give a more unstable income. An example of a product with this problem is coffee (Milford 2004:4). This could provide one economic rationale for a guaranteed minimum price (Becchetti and Rosati 2005:6).

Besides static gains from trade, there are dynamic gains. These include realization of economies of scale following access to larger international markets, and technology transfer (e.g. the product cycle). Some argue that when dynamic effects from trade are taken into

[15] This is called the *compensation principle* (Hausman and McPherson 1996:97-8).
[16] FLO (2006c:3).

account, specialization based on current comparative advantage may be harmful for long-term economic development. For example, it has been argued that specializing in agricultural products might be unfortunate because industrial production gives better opportunities for growth in the long run. However, I will not go into this debate here.[17]

I now discuss briefly how theories of justice may be used in connection with trade. Fairtrade has often explicitly stated that they are paying a fair price, rather than the market price. Recently the fairness dimension seems to have been downplayed somewhat, and the emphasis is now on how Fairtrade can help marginalised producers into international market, and provide extra benefits for them and the community around them (see FLO 2006c:2).

The fairness dimension has also been interpreted differently in the literature on Fairtrade. Maseland and de Vaal (2002:254) divide the "fairness" of Fairtrade into two distinct concepts: That we have a moral obligation to 1) pay a fair price for 2) a product that has been produced under decent conditions. In other words, fair trade involves on the one hand some minimum requirements for trade with respect to working conditions. As Maseland and de Vaal (2002:256) note, these are absolute requirements without which it does not make sense to talk about fair trade. The fair price, on the other hand, they argue is essentially a pure income transfer.[18] The concept of fairness they use for this is that trade should improve the situation of the worst off, in this case poor producers in the South.[19]

Adriani and Becchetti (2004:6) in their analysis of Fairtrade in monopsonistic labour markets identify a fair wage with the competitive wage, which they argue can be considered as the wage when the two counterparts have equal bargaining power. On the other hand, the liberalistic philosophy of Nozick (1974) would probably say that any outcome of trade is fair, as long as trade is voluntary. Considerations like equal bargaining power are then irrelevant.[20]

A satisfactory discussion of theories of justice and trade would of course require a thesis in itself. With the preceding brief discussion as a background, I now move on to look at some economic literature on Fairtrade.

[17] See e.g. Appleyard, Field and Cobb (2006), Almås (2005) and Snoen (2004) for a discussion.
[18] However, they also argue that a higher price could be used to pay for the costs of respecting standards (p.270).
[19] Maseland and de Vaal (2002:footnote on p.256) note that this concept is similar to John Rawls' (1971) ideas of social justice.
[20] This is my impression which is based on excerpts from Nozick (1974) cited in Beauchamp (2001:315-9), as well as on Hausman and McPherson (1996:132-3). However, this requires that today's situation is the result of past justice, so it is probably more correct to say that *in principle* any outcome of trade could be fair.

2.5 Economic theory on Fairtrade

In this section I briefly present some of the earlier economic literature on Fairtrade, which so far has mainly concentrated on the production side. Interestingly, the literature theorizes either that Fairtrade can address specific market failures, and can therefore be beneficial; or that it rather creates new market distortions, and thus may have adverse side-effects. A recurring theme is also that while it seems to be helping the people that participate in the system, Fairtrade may hurt others.

I first look at the literature that sees Fairtrade as a possible answer to market imperfections, notably problems of monopsony. Adriani and Becchetti (2004) study the entry of a fair trader into a market previously dominated by a firm with monopsony power in the South labour market. As mentioned above, in their model fairness means exactly that the firm pays the workers the value of their marginal product of labour.[21] The entry of the fair trader can lead to a welfare improvement both for the consumers in the North that are concerned with fairness, and for workers in the South. If the fair trader can take any size, all workers in the South will experience a welfare improvement, as the monopsonist will then have to pay the competitive wage to attract any workers at all. There will then only be produced fair products. If the fair trader is size-constrained, there is a critical size it needs to reach in order for all workers to experience a welfare improvement.[22] Interestingly, if it does not reach this size, its entry might lead to lower wages for the workers in the unfair firm, and unemployment for some workers.[23]

Milford (2004) studies Fairtrade via its effect on coffee–purchasing co-operatives in an area with oligopolistic or monopsonistic buyers of coffee. There are several ways in which the coffee co-operatives can improve the situation of the rural poor.[24] In theory, they can distribute the profits that would otherwise be retained by middlemen, to themselves. This means that they can offer a better price than their private competitors, which may enhance competition among local coffee purchasers. This effect however depends on what type of co-operative we are discussing, which I will not go into here, but we note that in Milford's model the entrance of a co-operative *might* lead to negative effects for the producers who are not members of the co-operative.[25] However, as Milford points out, the co-operative might have some positive effects beyond the model. They may for instance work as what Helmberger

[21] Interestingly, this also *increases* the value of the marginal product of labour.
[22] In addition, the fair trade needs to be able to efficiently ration the labour supply by recruiting the workers with the worst outside options (Adriani and Becchetti 2004:14).
[23] Adriani and Becchetti (2004:18).
[24] Milford (2004:64-65).
[25] Milford (2004:26).

called “barometers of exploitation”, indicating to non-cooperative workers the extent to which they are being exploited by the oligopolistic coffee buyers. The coffee buyers might then have to offer a better price in order to avoid that the farmers take actions like creating their own co-operative. The effect of the Fairtrade price premium is as a subsidy to worker-owned co-operatives which may allow them to have this pro-competitive effect.

Becchetti and Rosati (2005:5-6) mention other ways in which Fairtrade criteria may reduce market imperfections. For example, the opportunity of pre-financing production may help reduce problems with monopolistic moneylenders and credit rationing for small uncollaterized producers. Attention to the environmental sustainability of production may reduce problems with externalities. An important effect of Fairtrade may also be to facilitate trade by creating long-term relationships between the importers and producers, and offering services to the producers. Examples of such services may be information about consumer tastes in foreign markets, non-tariff trade barriers, import regulations, and the like. Raynolds (2002) emphasizes how Fairtrade by working directly with producers helps build local capacities.

The predominantly critical literature on Fairtrade on the other hand usually claims that Fairtrade does not address the fundamental problems, and that its main effect is instead to create new market distortions. For example, the most important reason that coffee prices have been very low, is overproduction.[26] One reason for this may be that coffee is one of the products that do not face trade barriers like duties and subsidies in the North.[27] Removing such trade barriers in the North is seen by many as an important strategy for helping poor countries.[28] *The Economist* argues that by paying a higher price for coffee, Fairtrade instead stimulates more coffee production, which makes the problem even worse.[29] While Ian Bretman of FLO replies that the poorest coffee producers have little chance of diversifying out of coffee production, and that the increased income from Fairtrade can allow them to diversify, *The Economist* emphasizes that Fairtrade in coffee reduces the incentive to diversify.[30]

In their reply to *the Economist*, FLO (2006d) claim that the theories of overproduction are unfounded, and that farmers are well aware of the risk of relying on only one product.

[26] Milford (2004:4).
[27] Milford (2005:1).
[28] See e.g. Stiglitz and Charlton (2005).
[29] *The Economist*, 7 December 2006: ”Voting with your trolley”.
[30] A related critique comes from Rune Skarstein, but from a different perspective. He claims that contrary to common belief, developing countries have a comparative advantage in the production of industrial products, and that they should therefore not specialize in agricultural products. This leads him to call Fairtrade in coffee “a bear’s service”. (*Forskning.no*, 25.04.2005).

Instead of increasing production (unless to meet specific additional demands), Fairtrade farmer groups therefore use the opportunities offered by Fairtrade to invest in developing their market knowledge, in building up their export and processing capacity, or in programmes for diversifying production.

More generally, it seems that distortionary effects between products from the South are not really arguments against the idea of Fairtrade as such, but rather that Fairtrade should be limited to a few products like coffee. But one could imagine Fairtrade in *all* products from developing countries.[31]

However, the view of Fairtrade as a market distortion stands strong among economists. This is because an important aspect of Fairtrade is the guaranteed minimum price, higher than the "market" price. Economic theory usually predicts that a minimum price, while helping some people, will have adverse side-effects for others. An example is a minimum wage. In a competitive environment, theory says that a minimum wage will lead to "involuntary unemployment" for some people. In monopsonistic labour markets, this might be different, since with a minimum wage the monopsonist can no longer influence the wage below this level. A minimum wage might then lead both to higher wages and higher employment.[32]

However, I will from now on abstract from problems like monopsony, and allow that *a priori*, Fairtrade causes a market distortion, by securing a minimum wage or price above the "market" level. In the introduction to their article on Fairtrade, Maseland and de Vaal (2002) write that

> "One can imagine that the practice of fair trade organisations might lead to market distortions that cause adverse effects if one takes on a more broad perspective". (p.252)

In a Heckscher-Ohlin-model for international trade, Fairtrade has the following effects:

> "The effects of paying the higher price for the products the poor country exports have more or less the same effect as imposing an import quota for this product. Whereas under free trade the poor country would start to export the goods which use its abundant factor intensively until the price differences between the countries would be

[31] See also Rygh (2006).
[32] Adriani and Becchetti (2004:footnote on p.6).

> completely eliminated, now it can only export until the price in the rich country has fallen to the fair trade level. Exports and international trade are thus limited by the fair trade program." (p.259.)

Whether or not the producers are better off, depends on how much trade is reduced, which again depends on the price elasticity for the good in question.[33] If trade is reduced a lot, a higher price per product sold might not compensate for the reduction in the number of products sold, and the producers might be worse off with fair trade.

A problem with this argument is that it assumes that Fairtrade is only a cost for the consumer, and that Fairtrade products provide no additional value. A different view, stressed by Becchetti and Rosati (2005:5-6), is that Fairtrade instead means creating a *new* market where consumers with preferences for fairness can buy "fair" products. To answer these questions, we must look closer at the consumer side in Fairtrade. This is done in the next chapter.

[33] Maseland and de Vaal (2002:259).

3 Fair consumers and economic modelling

Fairtrade is part of a wider phenomenon known as *ethical-political consumption*, and which has been growing in importance the last decades. In section 3.1 I give a short introduction to ethical-political consumption, and in section 3.2 an introduction to the related phenomena of ethical investment and corporate social responsibility. The treatment here will, however, necessarily be superficial.[34]

Many are sceptical of the merits of ethical consumption. In section 3.3 I discuss some criticisms. A suggested alternative, international legislation, is discussed briefly in section 3.4. In section 3.5 I discuss the economic modelling of consumer preferences for Fairtrade. This discussion serves both to evaluate some criticisms of Fairtrade presented in chapter 2, and to prepare the modelling in chapter 5. Finally, in section 3.6 I discuss the argument that concerned consumers could instead give money to the producers as direct aid.

3.1 Ethical-political consumption

A definition of ethical-political consumption, is *the purchase, use or disposal of goods as an expression of an ethical-political stance* (Terragni, Jacobsen, Vittersø and Torjusen 2006:13). An example of ethical-political purchases of goods is Fairtrade. Repairing old clothes instead of throwing them away can be an expression of concern for the environment, as is disposing of products by recycling them.[35] A well-known important type of ethical-political consumption is *ecological consumption*. This may also be due to concerns about health.[36] Often Fairtrade products are also certified ecological.[37]

It is useful to distinguish between *negative* and *positive* ethical-political consumption. Negative ethical-political consumption means choosing away products, like in traditional boycotts. Positive ethical-political consumption means that one actively chooses some products to buy. This has also been called “buycotts”.[38] An important consideration is consumers’ *choice*. Even if there is no “positive” alternative available, a consumer can in

[34] For a more complete treatment, see e.g. Føllesdal (2004) and Terragni, Jacobsen, Vittersø and Torjusen (2006), and Barnett, Cafaro and Newholm (2005).
[35] Terragni, Jacobsen, Vittersø and Torjusen (2006:13).
[36] Reynaud (2004:47).
[37] The certification for the ecological part of the product is done by other organizations. In Norway, this is done by Debio (Fairtrade Max Havelaar Norge 2007).
[38] Berg and Terragni (2006:9).

principle boycott any product which he or she finds immoral. Conversely, buycotts imply choosing away other products.

Føllesdal (2004:5-10) lists some main motivations for ethical-political consumers.[39] One is the *clean hands*-motive, which means that one wants to disentangle oneself morally from certain actions. Boycott has traditionally been used in this respect. For example, one may wish to avoid buying products made with the use of child labour. A second type of motives has to do with personal *identity*. Ethical-political consumption then becomes an expression of one's values, or of "mutual respect". Even if an act of ethical-political consumption is not able to achieve changes e.g. in firms' practices, a "symbolic" action may still have an expressive purpose. (Føllesdal 2004:7).

The third main type is *instrumental* motivations. In this case, consumer actions are meant to achieve some change. Ethical-political consumerism has arisen among other things as a response to the challenges of globalisation. Føllesdal (2004) discusses this from the perspective of political participation. As he writes,

> "Traditionally, political participation has involved the relationship between citizens and their government, which in turn regulates the market. Political consumerism adds to this conception in that citizens turn directly to the market with a variety of political concerns." (Føllesdal 2004:4).

One aim of ethical-political consumerism might be to reform business practices. I here emphasize that actions may be seen as supplementary to government action. They might be a permanent supplement to governments' power, or one may use extra-parliamentary means to get stricter government and intergovernmental regulation of business. Political consumerism might also be a more temporary measure while one waits for global regulation with sufficient enforcement power.[40]

I will from now on refer to "ethical consumption" for short.

[39] My presentation is based also on Jacobsen (2006).

[40] Føllesdal (2004:8). Adriani and Becchetti (2004:1) see Fairtrade from this perspective. For them, Fairtrade is a "bottom-up" welfare-improving mechanism, where fair consumers step in to address market imperfections such as monopsony, in the absence of a global social planner.

3.2 Ethical investment and CSR

Related to ethical consumption are ethical investment and so-called corporate social responsibility (CSR).[41] *Ethical investment* means that investors have ethical criteria for their investments in companies.[42] The Norwegian Government Pension Fund (a continuation of the former Petroleum Fund) has ethical guidelines for its investments, and recently decided to withdraw its funds from among others the American company Wal-Mart, due to the company's alleged bad practice with respect to among other things worker rights.[43] According to the Social Investment Forum (2005:iv), today almost one out of ten dollars invested professionally in the United States is involved in socially responsible investment. Ethical investment can also mean exercising shareholder power. As Hertz (2006) writes, more and more shareholders in companies now not only accept social responsibility, but demand it. One important reason is that social responsibility is becoming profitable.[44]

Corporate social responsibility (CSR) refers to the view that firms, rather than just maximizing profits, have a responsibility to take into consideration the effects of their actions on e.g. workers and the environment. As Terragni, Jacobsen, Vittersø and Torjusen (2006:19) point out, some responsibilitites are already institutionalized through legislation. In addition, many firms make their own *codes of conduct*, guidelines for the responsibilities beyond existing legislation, for example in connection with the environment, corruption, ethics, and conditions for their workers. It is these codes of conduct, and the systems of implementing and reporting them, we normally combine with CSR. CSR is often expressed through the idea of a "three-part" bottom line, where firms in addition to their "economic" activity, are expected to report about environmental and societal concerns. The impact on society and the environment is often represented in so-called social and environmental accounting, firms' own reports about these concerns.[45]

Terragni, Jacobsen, Vittersø and Torjusen (2006:20) identify three main motives for CSR. First, it might contribute to protect the firms from reputational risk in generic markets ("blame management"). The idea is that in some industries, firms face a low general level of consumer trust about their social responsibility. This general consumer trust might be seen as

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[41] There is also *ethical banking*, represented in Norway by e.g. Cultura Sparebank which has ethical criteria for its loans.

[42] In fact, ethical investment is not new, but originated with the Quakers who wanted to avoid investing in products which went against their beliefs. See Ferone (2004).

[43] *Dagbladet*, 07.06.2006. See Norges Bank (2004) for the ethical guidelines. The current Norwegian government is also working on guidelines for state-owned firms. See *Aftenposten*, morgen, 08.12.2006, p. 5.

[44] Becchetti and Fucito (2000) find that socially "screened" investment portfolios do not give lower returns than global portfolios.

[45] See also Adams and Zutshi (2005).

a public good for firms. However, some firms may want to privatize consumer trust by differentiating themselves from their competitors, and making their particular brand appear more socially responsible. However, this also means a privatization of *risk*. If the firm is caught treating its workers badly, its particular brand will be attacked.

CSR might also contribute to market differentiation by building brand value, which again allows the firms to charge a higher price. Finally, CSR might simply be a way to achieve ethical actions, and might also help motivate employees.[46]

3.3 Criticism of ethical consumption and CSR

For different reasons, people are critical of ethical consumption and CSR. A first critique concerns unintended and harmful side-effects. For instance, boycotting a product made using child labour will often mean that the children instead end up in the street.[47] Snoen (2004:135) notes that organizations like UNICEF and Save the Children normally do not support boycott as a means for fighting child labour, since the alternative for the children will usually be worse.

Many are also sceptical of the effectiveness of ethical consumption.[48] Runar Døving considers fair trade to have little opportunities at a lower level than the EU.[49] Eriksen and Tretvoll (2006) think that ethical consumption leaves too much to consumers' conscience. The same scepticism concerns what can be achieved by firms' voluntary CSR.[50] One important problem is that it is often difficult to verify that the firms in fact respect their own voluntary guidelines, and the chances for the firms of being caught are small.[51]

Others criticise CSR for interfering with market principles. This view is often summarized by the famous statement by Milton Friedman that "the business of business is business".[52] Henderson (2001) is concerned among other things that CSR will lead to reduced

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[46] In the context of environmental protection, Reynaud (2004) identifies three strategies for firms facing concerned consumers. The first group of firms, finding protecting the environment costly and perceiving the market as less sensible to environmental concerns, have a strategy of "wait and see". The second group, on the other hand, anticipates a growing concern among consumers. For this group, protecting the environment becomes a commercial argument. The third group of firms are pro-active, and seek both to influence consumers that until now have been less sensible to the environment, and to get environmental protection on their own terms.

[47] See Føllesdal (2004), Snoen (2004) and Adriani and Becchetti (2004).

[48] *Ny Tid* nr. 47, 1.-7. desember 2006, pp. 51-55, and *The Economist* 7 December 2006.

[49] *Ny Tid* nr. 47, 1.-7. desember 2006, p. 53.

[50] See e.g. Doane (2005).

[51] Gaarder (2004:104). See also Adams and Zutshi (2005).

[52] Friedman's (1975) argument mainly considers the board of the firm, notably that they should not spend the shareholders' money on social responsibility.

economic performance and hence reduced welfare for society as a whole.[53] Yet other problems with ethical consumption and CSR are of course that there might be disagreement as to what is in fact "ethical". As Dickinson and Carsky (2005:25) point out, boycotts have been used both to harm and to support the state of Israel.[54] Finally, a problem is what we would call "unethical" consumption, based e.g. on racism.

3.4 Ethical consumption and CSR versus legislation

The limitations of consumer voting and CSR are one reason that in response to the problems under globalisation, many instead turn to international legislation. The International Labour Organization (ILO) today has standards for working conditions, but no effective means of enforcing them.[55] However, possibilities of enforcement exist in the World Trade Organization (WTO).[56] Many therefore want standards for labour and the environment in the WTO. However, developing countries themselves oppose such standards, as they fear that standards will just be hidden protectionism by developed countries.[57] Respecting standards might also lead to higher production costs for the developing countries, and therefore reduce their competitiveness, which could lead to reduced trade. Though some workers will have better working conditions, if trade is reduced a lot, the overall welfare effects of international standards for workers in the South could be ambiguous.[58]

3.5 Economic modelling of preferences for Fairtrade

We now look at how to model consumer preferences for Fairtrade. First, we establish what seem to be the most important empirical characteristics of such preferences. Becchetti and Rosati (2005) find that the revealed preferences of many consumers show that they are willing to pay in excess of the market price for the social features of Fairtrade products.

I said in the introduction that it does not seem relevant to model Fairtrade using exclusively self-interested consumers, so we need to include some notion of preferences concerning other agents. Fehr and Fischbacher (2002:C2) define *social preferences* in the following way:

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[53] See Henderson (2001:15-8).

[54] See Fershtman and Gandal (1998) for a discussion of the economic effects of the Arab boycott of Israel in the automobile market.

[55] See Goel (2005:49-53) for a presentation of the *ILO Declaration on Fundamental Principles and Rights at Work*.

[56] *Ny Tid* nr. 47, 1.-7. desember 2006, p. 55, Eriksen and Tretvoll (2006). See Hoekman and Kostecki (2001), chapter 3 for a discussion of the enforcement of rules in the WTO.

[57] Hoekman and Kostecki (2001), *Ny Tid* nr. 47, 1.-7. desember 2006, p. 55.

[58] Note that this argument is similar to the one of Maseland and de Vaal (2002).

> "A person exhibits social preferences if the person not only cares about the material resources allocated to her but also cares about the material resources allocated to relevant reference agents."

One of the first to include social preferences in an economic model, seems to have been Sen (1966), who let the members of a worker co-operative have preferences for the welfare of the other members. One important strand of economic research on social preferences started with Akerlof's work on labour contracts as a partial gift-exchange.[59] Fehr and Fischbacher (2002:C2) point out that in the last 15 years there has been a large number of studies indicating that in addition to material self-interest, social preferences shape the decisions of a substantial fraction of people. The three most important types of social preferences are the following: *Reciprocity* refers to the desire among people of repaying kindness with kindness, and unkindness with unkindness (Nyborg 2006c). *Inequity aversion* means that the agents dislike inequality.[60] *Pure altruism* means kindness that is not conditional on kindness received. Technically, altruism means that an agent values the material resources allocated to relevant reference agents positively (Fehr and Fischbacher 2002:C4).

To delimit the concept of social preferences to make it suitable for Fairtrade, I follow Becchetti and Rosati (2005), who extend the concept of *relevant reference agents* to include also workers in developing countries. As they write,

> "(…) global market integration has led to a compression of distances and to an enlargement of the potential reference group considered when social preferences are formulated. (…) We argue that the progressive integration and reduction of virtual distances leads a share of "concerned" consumers to care about distant people, integrating them in the set of their relevant reference agents." (Becchetti and Rosati 2005:3)

As I will now show, how one models these social preferences is important. In section 2.5 I argued that Maseland and de Vaal's (2002) analysis rests on dubious assumptions about the consumer side in Fairtrade. As Maseland and de Vaal see it, Fairtrade is a question of *duty*, which corresponds to an absolute constraint on the actions the consumer may take:

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[59] See Becchetti and Rosati (2005).

[60] Becchetti and Rosati (2005) use this concept in connection with preferences for Fairtrade.

> " 'Fair trade' in this paper refers to the consumer movement that has come up in several Western countries in the past decades, in which *people feel morally obliged to pay prices above market level for products produced under certain conditions in Third World countries*. Crucial in this practice is that restricting oneself to goods produced under these conditions and paying higher prices are both considered to be moral obligations rather than preferences (…) The fact that fair-trading is a moral obligation means that there is no trade-off possible between these principles and consumer preferences (…) Such principles can be seen as 'ideological constraints' analogous to a budget constraint; preferences have to be weighed within such constraints, which are themselves not part of the utility function". (p.252-3).

This formulation can explain the fact that consumers buy fair products for a higher price, and it also has some intuitive appeal. However, I now argue that the "ideological constraint" formulation of preferences for Fairtrade is problematic. There are two reasons for this. First, I think few consumers see Fairtrade as an absolute duty, overriding all other concerns, such as price and quality. Second, because fairness is not included in the utility function itself, but is modelled as a constraint on utility maximization, Maseland and de Vaal's formulation excludes the possibility that consumers derive value from the fact that a good is fair.

To see more clearly what this means, consider a consumer who would have three cups of coffee a day if he paid the "market" price for the coffee. However, the consumer feels morally obliged to pay a "fair" price for the coffee. Since Fairtrade coffee is just the same thing as ordinary coffee, he will reduce his consumption of coffee following his price elasticity. This could e.g. mean that he will have only two cups of "fair" coffee. However, if the fact that the coffee is fair provides additional value, he might not reduce his consumption much. In other words: *a price increase due to the fairness of a product is perhaps not the same as any other price increase.*[61]

This can be shown more clearly by the following division of the values that consumers derive from a good.

1. *"Self-interested" values.* These are the values that a consumer would care about if he had no social preferences. These include taste, quality etc.

[61] This idea will also be important when I discuss international standards below.

2. *"Social" values.*[62] These include whether a good is produced under decent working conditions, whether production is environmentally sustainable, and whether the producers receive a decent price.

In Maseland and de Vaal (2002), there are only self-interested *values* for the consumer, in the sense that only these give the consumer *utility*, while the "social" values enter only as constraints on utility maximization. We must then also conclude that the consumer would have had a higher utility if he was not constrained by moral considerations. This implicit assumption that Fairtrade is just a cost for the consumer, and gives him or her no value, underlies much of the criticism of Fairtrade. However, it might represent a too narrow view of consumers' motivations. Peter Singer (2006) puts this in the following way:[63]

> "If people want to pay $ 48 for a pound (0.45 kg) of Jamaican Blue Mountain coffee because that's what James Bond prefers, economists don't object that the market is being distorted. So why be critical when consumers choose to pay $ 12 for a pound of coffee that they know has been grown without toxic chemicals, under shade trees that help birds to survive, by farmers who can now afford to feed and educate their children?"

The fact that many consumers derive additional value from the "fair" characteristics of Fairtrade products can be represented by an altruistic preference formulation.[64] In such a formulation, consumers have preferences over the quantity of the good, but also over the welfare of South workers.[65] This is the "classical altruism" formulation (Nyborg 2006a):

[62] These could also include "antisocial" values. See Bojer (2003:32-4) for a discussion of antisocial preferences. However, I here disregard this possibility. Note also that environmental-friendly production here does not imply traditional externalities. The consumer might care about environmental-friendly production in distant countries even if his or her own consumption is not affected.
[63] *The Japan Times*, Sunday, April 23, 2006.
[64] If one insists that Fairtrade "in reality" means a cost to the consumer, one might defend the use of an altruistic preference function by invoking an "as-if" argument. One could then argue that even if Fairtrade "in reality" means a cost to the consumer, an altruistic preference function where things are "as if" the consumer derived additional value, is better suited for modelling, because its predictions might fit better with what we observe. For more on "as-if" arguments and the debate surrounding them in economics, see Nordberg and Røgeberg (2003), Torsvik (2005) and Hanisch (2003). Note also that I have rejected an "as-if" argument with purely self-interested agents.
[65] Becchetti and Solferino (2004) use a Hotelling model of product differentiation, reinterpreting distance as the "ethical distance" of a product from the consumer's ethical standards. Other things equal, the longer this distance, the lower his or her utility.

$$U_i = U(X_i, U_{-i}) \tag{3.1}$$

X_i is agent *i*'s consumption of the good, and U_{-i} is the outcome for South producers. Unlike the "ideological constraint" formulation, this formulation allows for both self-interested and social values.[66]

However, also this model has some short-comings. Nyborg (2006a) points out that research on contributions to public goods, has shown that this type of altruism cannot explain the level of voluntary contributions. This is because even if people care about their own and other people's access to the public good, they would like other people to pay for it. This means that we have a "free-rider" problem. However, agents may also have preferences for contributing to the public good themselves. According to the "impure altruism" theory, contributing oneself creates a "warm glow of giving", which may be seen as a private good.[67] The impure altruism model has been used to analyze the demand e.g. for eco-labeled goods and recycling (Nyborg 2006a).

We can make a similar argument for Fairtrade. As Hausman and McPherson (1996:63) point out, people may prefer a high level of consumption for the poor, but if they have no preferences for the process, they prefer other people to pay for it.[68] However, if people have preferences for contributing themselves, the free-rider problem goes away.

The discussion in this section is summed up with the following "impurely altruistic" utility function, adapted from Nyborg (2006a):

$$U_i = W(X_i, U_{-i}, P_i) \tag{3.2}$$

X_i is agent *i*'s consumption of the good, U_{-i} is the outcome for South producers, and P_i is agent *i*'s own purchase of Fairtrade goods. Importantly, different consumers might have different preferences over these concerns. In the analysis in chapter 5, I simplify by disregarding the argument U_{-i}. This may be justified by the fact that each consumer's contribution to the overall outcome is in any case negligible.

[66] Of course, there is nothing in the way of *combining* the two approaches. One could e.g. postulate a minimum ethical requirement below which the consumer will not go in any case (i.e. an absolute constraint), while allowing for altruistic preferences for ethics above this minimum level.
[67] The private good provided by one's own contributions might be the consumers' self-image as a socially responsible person, or social approval from others. The concept of self-image might be related to what Føllesdal (2004:7) calls arguments of identity. The role of social approval is discussed by Nyborg (2006). However, I will not pursue these interpretations further here.
[68] Jon Vislie aptly called this "opportunistic altruism".

3.6 Fairtrade versus direct aid

After having discussed consumer preferences for Fairtrade, it seems suitable to discuss the argument that Fairtrade is an inefficient way for consumers to satisfy their social preferences. *The Economist* claims that retailers add large mark-ups to Fairtrade products and mislead consumers into thinking that all the premium they are paying is passed on to the producers. According to Harford (2005), only 10% of the premium paid for Fairtrade coffee reaches the producer.[69] Instead of buying fair trade products, the consumers could just give the money directly to the producers in the South as aid.

If it is indeed the case that most of the Fairtrade premium does not go to poor producers, the legitimacy of the system is in danger. However, in my view this is not really an argument against the *idea* of Fairtrade. It is better seen as an information problem where retailers exploit private information to extract a rent from ethical consumers.

Besides this, it has been argued that Fairtrade has some advantages compared to direct aid. Becchetti and Rosati (2005: footnote on p.7) mention some possible advantages. First, as we saw in section 2.5, Fairtrade may increase competition in labour, credit and product markets. It might also facilitate trade and provide other important services to the producers. These effects are absent with aid. In addition, Becchetti and Rosati point among other things to the fact that charity does not necessarily reward productiveness; that joining consumption and social transfer reduces transaction costs of aid to the poor compared to the traditional tax financed government aid scheme; and that the Fairtrade "bottom-up" mechanism might be more efficient than subsidies to the government in targeting the poor. This last point is relevant if one is concerned that aid often disappears in corruption in poor countries. Also, fair trade has the effect of triggering socially responsible imitation among traditional, profit-maximizing producers.[70] Also this "ethical benchmarking" effect is absent with traditional aid. Finally, in the debate on trade versus development aid, it is often argued that trade gives more dignity for the producers than just receiving aid. Fairtrade must then also give more dignity than just receiving aid.[71]

[69] *The Economist* 7 December 2006. Tucker (2006) also mentions such allegations.
[70] See also Becchetti and Solferino (2004).
[71] See however Vramo (2006) for an interesting discussion of the Western dichotomy between trade and aid ("gifts").

4 Market failures in the provision of fair goods

In chapter 4, I ask the following question: Is a private market able to sufficiently accommodate social preferences for Fairtrade? As is discussed in section 4.1, one crucial assumption for the competitive model in economics is information. In sections 4.2 – 4.4 I argue that there are market failures in the provision of information about the ethical features of goods. The problem essentially arises from firms' private information about the fairness of production, and the fact that it is usually too costly for the ethical consumer to search such information. In section 4.5 I discuss the main argument against the theory, namely the development of private labelling schemes like Fairtrade. Finally, in section 4.6 I briefly discuss some other costs of ethical consumption.

4.1 Information about the ethical characteristics of goods

At least since the famous article by Akerlof on the market for "lemons", the role of information has been seen as crucial in economics.[72] Ethical consumption is no exception. In order for ethical consumers to be able to satisfy their altruistic preferences, they need information about the production process, with regard to working conditions, impact on the environment, and the like. Ethical information is in many ways a particular form of information, as it often concerns not primarily the characteristics of the product as such.[73] In addition, while a consumer will usually find out sooner or later whether the car he bought was a "lemon", he will perhaps *never* know the truth about the conditions for workers in the production of the good he bought.

4.2 Ethical risk

Suppose an ethical consumer is considering buying a pair of jeans labelled "Made in China". He or she might have read in the newspaper about the bad conditions for workers in a clothes

[72] Akerlof (1984), chapter 2.

[73] Important exceptions are e.g. ecological consumption and food produced using genetically modified organisms (GMO). More generally, one can say that economic theory usually has seen this type of information as irrelevant for consumers, and even normatively something consumers should not be concerned about (see Vramo 2006:12-3). On the other hand, Per Persson says that Fairtrade also means buying the history of a product. (*Verdensmagasinet X*, nr. 6 2006, p. 44). Lancaster (1966:133) argues that we should break away from the traditional approach of seeing goods themselves as the direct objects of utility, and instead suppose that it is the "properties" or "characteristics" of the goods from which utility is derived. Among such characteristics might be the "history" of the product. However, this discussion is beyond the scope of this thesis.

factory in China. The consumer is now concerned that these jeans might have been produced under similar conditions. This uncertainty about the fairness of production, which reduces the ethical consumer's utility of the good, might be called *ethical risk*. Recent surveys indicate that a non-negligible number of consumers experience such ethical risk. In October 2006, Opinion conducted a survey for NORAD on Norwegian consumers' attitudes towards products from the South. 45 percent of the respondents said they felt guilty because they bought products they were not sure held a certain ethical standard.

At the same time, 85 percent of the respondents agreed that trade with developing countries contributes to development, and they therefore wished to buy more products from developing countries.[74] When 51 percent also think that the risk of bad working conditions is a reason not to buy products from developing countries, it seems that consumers are often unsure whether buying products from the South in fact contributes to development.[75] This is another way of looking at ethical risk.

To avoid ethical risk, the ethical consumer has two strategies: Either search *ethical information*, or buy goods that he or she for different reasons trusts are "fair".

4.3 Consumer strategy 1: Search for ethical information

It is now possible to find more and more ethical information. For example, there are many specialist internet sites and magazines providing consumers with such information.[76] Many of these are run by non-governmental organizations (NGOs). However, the individual consumer needs to put in a lot of effort to find and make use of this information. Eidi Ann Hansen, editor of the Norwegian internet portal for ethical consumption, *Etiskforbruk.no*, noted that when she now has an overview of what it is okay to buy, and what one should avoid, this is only because she has been able to use several work days in searching for the right information.[77] These search costs are an additional cost of ethical consumption, over and above the isolated "fair" price. Probably for most consumers, the costs of searching for ethical information for use in everyday shopping, are near prohibitive.[78]

Another concern is the quality and independence of the information. As noted in section 3.2 above, firms publish reports about their activities in relation to social goals and the

[74] Opinion (2006:3).
[75] Opinion (2006:13).
[76] In appendix B I give some examples of important sources of ethical information.
[77] *Ny Tid* nr. 47, 1.-7. desember 2006, p. 55.
[78] In addition, as Sigbjørn Hjelmbrekke pointed out to me, firms often have shares in other firms, who might have unfair production, or have shares in other firms again, etc. making it virtually impossible to keep track of the ethics.

environment. However, since such information is hard to verify, the consumer might be sceptical about the firms' own claims to fairness. Some authors are also sceptical of NGOs' important role as providers of information. As Føllesdal (2004:17) notes, quality control is a challenge even for the most well-intentioned NGOs. Also the lack of quality-control of the myriad sources for ethical information on the Internet is a problem.

4.4 Consumer strategy 2: Buy "safe" products

A possible consequence of the costs of finding reliable ethical information is that the consumer might turn to another strategy of reducing ethical risk, namely buying "safe" products. As mentioned, for many types of products there does not exist a Fairtrade alternative. In this case consumers might choose to buy products produced in the North countries rather than in the South, for example due to labour legislation in the North that they trust is effective.[79]

This means that ethical risk could theoretically represent a problem not just for concerned North consumers, but also for the South, if it reduces trade. The practical importance of this is unclear. Still, in the survey by Opinion, 85 percent of consumers claimed that they would to a larger degree buy products from the South if they were labelled "fair trade". 64 percent of consumers also declared a willingness to pay a higher price for a guarantee that products have been produced in a fair manner.[80] This indicates that the removal of ethical risk could mean that more consumers would buy products from the South.

4.5 Ethical product labelling: a public good?

Consider now that if the relevant ethical information can be summarized in a simple "ethical" label on the product, the information is costlessly available to all consumers. This means that ethical labelling seems to have the characteristics of a *public good* in the economic-theoretical sense.[81] A public good is a good with the following characteristics: There are large fixed costs in connection with producing the good, but when it is first produced, the costs of allowing one additional consumer access to the good is negligible. The theory of public goods then suggests that each individual will hope to free-ride on the others by letting them incurring the costs of providing the public good. Even if the consumer has quite strong altruistic preferences, the

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[79] In fact, there is a third strategy. In the face of overwhelming amounts of ethical information, the consumer may instead turn to his or her social networks for information about what to do. See Terragni, Jacobsen, Vittersø and Torjusen (2006:27). Also, NGOs have an important role in coordinating consumers in boycotts. See Innes (2006). However, I will not discuss this further here.
[80] Opinion (2006:25).
[81] See Varian (1992), chapter 23 for a discussion of public goods.

costs of searching ethical information might be too high. This could suggest that a private market will lead to a too low provision of ethical information, which means that *a priori* the authorities might have a role to play.[82]

4.6 Can private labelling schemes provide sufficient fair labelling?

However, the above theory immediately meets the objection that there today exist many different “fair” labels. Some of these are by independent, non-profit labelling schemes like Fairtrade. In economic theory, these schemes could be represented by a non-profit, altruistic agent willing to incur the fixed costs of providing the label. In addition, many firms today have their own “fair” brands. Does this mean that a private market, due to altruistic agents, after all is able to provide an “efficient” supply of fair goods?

My main objection is that there exist Fairtrade alternatives only for certain products, mostly primary commodities like coffee and bananas. For many other types of products from the South, there is no fair alternative. Fairtrade labelling of clothing, for example, only concerns the production of the cotton, and not the rest of the production chain.[83] As Engler (2006) notes, even if the cotton is Fairtrade, there is no guarantee that workers are not being exploited at the other steps of the production process. The fact that there exists Fairtrade labelling for some products from poor countries, but not other products, might be important. One might think of at least two explanations for this.

First, one might argue that there is less need for fair labels in other types of goods than primary products. Possibly, some characteristics of primary products make the producers especially vulnerable. For example, in section 2.4 it was argued that characteristics of agricultural products make the producers’ income more volatile. Another possible argument is that as developing countries now move up the product cycle, there is an increasing content of knowledge in production.[84] This will increase workers’ bargaining power and make them less vulnerable to exploitation. Hence, there might be less need for Fairtrade.

However, as we have seen also in the textile industry there have been many reports of bad conditions.[85] Further, a knowledge-intensive product like a mobile phone might be the result of a series of less knowledge-intensive operations, where workers continue to have low

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[82] A problem in practice is of course *what information* should be included on ethical product labels, among other things what level of detail the information should have. For example, behind the Fairtrade label lie detailed standards that are different from product to product. Probably few Fairtrade consumers consult these standards, and they instead trust the label and the text on the product. I here disregard this problem.

[83] Engler (2006), *Ny Tid* nr. 47, 1.-7. desember 2006, p. 51.

[84] A good example is the rapidly growing information technology sector in India.

[85] See e.g. Klein (2000), Ransom (2001) and Gaarder (2004).

bargaining power. A couple of years ago, for example, mobile phone company NOKIA was accused of exploitative conditions in its factories in Asia, where workers assemble mobile phones.[86] Ransom (2001:26-7) describes the bad conditions in a TV factory in Mexico. Therefore, we cannot conclude that there is necessarily less need for Fairtrade in other products than primary products. The important division seems instead to be between skilled and unskilled labour, as is emphasized by Adriani and Becchetti (2004:1).

To me, a more plausible explanation for the fact that there is fair labelling of some products, but not others, is that there are differences between products in how easy it is to establish fair labelling. It might require fewer resources to label simple products like coffee, than products like clothes that have a more complex and less transparent production process.[87] The different parts of production here happen in totally different places, if not totally different countries. Ragnhild Hammer of Fairtrade Max Havelaar Norge says that since the production of Fairtrade cotton is still low in volume, they have a reasonable overview of where the cotton goes later.[88] But if the volume were to become large, controlling this may require a lot of resources. The problem might be even greater for more complex products like mobile phones. An important characteristic of globalisation is exactly the splitting up and outsourcing of production to various countries.[89] Simon Pahle at the university of Ås also argues that the shorter the delivery chain, the larger is the possibility that pressure from consumers will have an effect.[90]

Some factors however pull in the opposite direction of what I have said above. For example, in the case of clothes, the ethics in the rest of the production chain could be maintained through other labels of certification.[91] However, there have been some problems with quality control for such standards.[92] It might also be easier to ensure fair production within the walls of a factory. But as Gaarder (2004) points out, e.g. in the textile industry the trend today is for firms to have fewer people employed in factories, and instead putting out work to home-workers.[93]

[86] *svt.se* (2005).
[87] See Ransom (2001:97).
[88] *Ny Tid* nr. 47, 1.-7. desember 2006, p. 51.
[89] A good example (though perhaps not the most relevant in the context of Fairtrade) is cars. According to Box 2.4 in St. Meld. nr. 19 (2002-2003), the production of a certain car by a large American car producer is based on contributions from no less than nine countries.
[90] *Ny Tid* nr. 47, 1.-7. desember 2006, p. 55.
[91] *Ny Tid* nr. 47, 1.-7. desember 2006, p. 51. Some important standards are discussed in Goel (2005).
[92] Gaarder (2004:108-10).
[93] Gaarder (2004:64-71).

As mentioned, many firms today have their own fair brands. However, there have been examples that production in fact was not quite "fair".[94] Crane (2005) notes that there seems to be scepticism among consumers about the fairness of many such brands.[95]

Though there is obviously need for more research on this, I think the argument that ethical labelling has the characteristics of a public good is reasonable. However, a particularity about this public good is that is also has consequences for people in the South, which need to be taken into consideration in public policy.

4.7 Other costs of ethical consumption

Though it seems reasonable to claim that searching ethical information is an important cost for ethical consumers, such costs cannot explain why the share of Fairtrade coffee only makes up 1.5 percent of the total sales of coffee in Norway. If one is not ready to accept that this means that most consumers in fact do not care about the fairness of production, part of the explanation for the low Fairtrade share might be that searching ethical information is not the only extra cost associated with fair consumption. I end chapter 4 by briefly discussing some other costs of ethical consumption. The discussion is to a large extent based the situation in Norway.

One important additional cost for the consumer is the lower product range.[96] Though one can find Fairtrade coffee in most shops in Norway, there is usually only one type, while there are many types of "ordinary" coffee. The problem of lower product range is however smaller in other countries like France and the UK. This might be part of the explanation why the Fairtrade share of the coffee market is 20 percent in the UK. "Fair trade" products have traditionally also been associated with lower quality. This impression lives on today e.g. in the mentioned article by *The Economist*, who write that coffee drinkers find the quality of Fairtrade brews to vary widely.[97] However, it is not my impression that most coffee drinkers find the quality of Fairtrade coffee inferior.

Another important cost for consumers buying fair products used to be that one might have to travel far to find a specialized shop with the products. This cost is now much less important, as most supermarkets today have Fairtrade products. However, many supermarkets

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[94] However, neither the Fairtrade schemes are free of such problems. I return to this in chapter 6.
[95] As Terragni, Jacobsen, Vittersø and Torjusen (2006:27) point out, the proliferation of labels might end up confusing the consumers, who might not be able to tell the difference between official labels that are certified according to approved standards, and "quasi-labels" for which there are no independent systems of certification.
[96] See also Becchetti and Rosati (2005).
[97] *The Economist* 7 December 2006.

still have only some of the products, and some of the largest chains currently have only Fairtrade coffee in many of their outlets.[98]

Finally, but not least importantly, Fairtrade products have to compete about the consumers’ attention with many well-established brands. With limited marketing resources, this might also be an explanation for the low share of Fairtrade products. In addition, Fairtrade products have, like ecological products, often been placed in less visibly in the shops. However, when they are fronted by the shops, results improve (Berg and Terragni 2006:13).

Some of the additional costs of Fairtrade might be falling in the number of buyers of Fairtrade products. One example is the costs of distribution. If there are few consumers, costs might be high, and only the most concerned consumers will buy Fairtrade. However, if many consumers buy the products, the cost per product might be much lower. This may mean that one needs a critical mass of Fairtrade consumers to be able to have Fairtrade on a larger scale. Public policy could here perhaps help by coordinating agents.

[98] An overview of the distribution of current Fairtrade products in Norway on the supermarket chains is given in Appendix D.

5 Public policy

In chapter 5, I assume that the theory of ethical labelling as a public good in chapter 4 is correct. For simplicity, I assume that the costs of searching ethical information are *prohibitive*. This means that without ethical labelling, consumers have no way of knowing whether a good (e.g. a pair of jeans) from the South is fair or not. I then set up a model framework to study the welfare effects in the North and the South of different public policies. The first, which I call Public policy 1, is ethical labelling of all goods from the South. The second, Public policy 2, is ensuring a fair South alternative. The third, Public policy 3, is international standards. I also briefly discuss a Public policy 4, public ethical investment.

5.1 A model framework

I propose that the effects of different public policies depend on the preferences, ethical information and beliefs of North consumers; on the reactions of firms in the South; and on the conditions for South individuals. In the following, I present a model framework with weight on these three groups of agents.

5.1.1 Individuals in the North

We look first at consumers in the North. In section 3.5, I argued that a formulation of preferences for fair trade should incorporate the following elements. First, the fairness of a good should potentially give the consumer additional value. Second, the weight given to fairness considerations should vary among individuals. A useful preference formulation which allows for this is provided by Adriani and Becchetti (2002, 2004). The consumer framework in my model is based on their formulation.[99] I first present the general preference framework, and then show how one can introduce consumer uncertainty about the fairness of goods.

Like in Adriani and Becchetti (2004), North consumers consume a single good x, which is traded internationally but consumed only in the North. There is a uniformly distributed continuum of consumers indexed by the parameter α which takes values between 0 and 1. Consumers' welfare is increasing both in the quantity of the good and its fairness. However, the relative importance of quantity and fairness differs between individuals. Apart

[99] These are two versions of the same article. My exposition of the preference framework is based on the earlier version of the article from 2002.

from fairness considerations the good is homogenous, i.e. it does not matter for the consumer if the good as such is produced in the North or in the South.[100] This means that I abstract e.g. from differences in quality. The utility function (see Adriani and Becchetti 2002) is

$$U(q;g;h;\alpha) = (gh)^{\alpha} q^{1-\alpha}; \alpha \in (0,1) \quad (5.1)$$

q denotes the quantity consumed of the good. Fairness is measured along two dimensions: Whether the good is produced in the North or in the South, and on whether production is "fair" or "unfair". The disutility for the consumers of a good being unfair is measured by the qualitative variable g, which takes the value 1 if the good is fair, and $\rho < 1$ if the good is unfair.[101] The value of a good being from either the South or the North is measured by the qualitative variable h, which takes the value 1 if the product is produced in the North and θ (any positive value) if it is produced in the South. If θ is greater than 1, consumers prefer South products. This may for example be due to a belief that they are helping poor South producers with fewer outside options than North producers. Note that g and h enter symmetrically in the fairness of the good. We may call the product gh the *Fairtrade variable*, since it incorporates the two dimensions of Fairtrade: Supporting South producers while guaranteeing fair production.

For most of the time, I will use the assumptions of Adriani and Becchetti (2004:8) that $\theta > 1$ and $\rho\theta < 1$. This means that although consumers prefer a fair South product, their second best choice is a fair North product rather than an unfair South product (for equal prices).[102] The different weights individual consumers put on quantity and fairness depend on the parameter α. Consumers with a low α derive their utility mainly from the quantity consumed, while consumers with a high α derive their utility mainly from the fairness of the product.

Ethical risk

While Adriani and Becchetti (2004:8) assume that the origin and fairness of production can be costlessly observed by consumers, I introduce *uncertainty* about the fairness of the goods.

[100] Alternatively, one could assume that the South goods are *perfect substitutes* for some other type of North goods.
[101] In this model, fairness refers to an exogenously given "fair" wage. I abstain here from discussing different conceptions of fairness, and refer the reader to section 2.4 above.
[102] The case $\rho\theta > 1$ is however also interesting. It could e.g. follow from a belief that even though conditions are very bad for workers in poor countries, it is after all still better to trade with the South. In fact, in the model here the consumers would be right in this.

Without fair labelling, consumers cannot know whether a particular good is fair or not. However, I assume that consumers are able to use *country-of-origin labelling* to form a probability distribution over the possible outcomes. I simplify by assuming only two possible countries of origin, North and South. There are two possible outcomes, fair or unfair. When consumers see the label "Made in South", they expect that the good is fair with probability p and unfair with probability $(1-p)$. As is discussed later, this subjective p may or may not be accurate.[103] For simplicity, I assume that when consumers see the label "Made in North", they feel *sure* that the good is fair (they assign a probability $r = 1$ to this outcome). This is due to legislation in the North, which consumers trust is effective. The uncertainty in the model is therefore over whether the South good is fair or not.

North consumers' expected utility functions are given by

$$EU_N = r\left[q^{1-\alpha}\right] + (1-r)\left[q^{1-\alpha}\rho^{\alpha}\right]$$

$$= q^{1-\alpha} \tag{5.2}$$

if they consume the North product,[104] and

$$EU_S = p\left[q^{1-\alpha}\theta^{\alpha}\right] + (1-p)\left[q^{1-\alpha}(\theta\rho)^{\alpha}\right]$$

$$= q^{1-\alpha}\theta^{\alpha}(p + (1-p)\rho^{\alpha}) \tag{5.3}$$

if they consume the South product. Note that since the consumer has no way of knowing whether the good he has bought is fair or not, this will also be his or her *actual* utility from consuming the good. In other words, *ethical risk* reduces the consumers' utility of the South good.

A high p means that consumers feel confident that the South good is fair. The ethical risk when they buy a South good is then low. A ρ that is close to 1 means that the average consumer puts little weight on the fair production dimension of fairness. In this case, p matters little. On the other hand, if ρ is close to 0, the average consumer is very unfairness-

[103] The determinants of p are obviously of interest. Though I do not here model a process for the formation of p, some comments on this will be made in the analysis that follows.
[104] Using the assumptions that $h = r = g = 1$.

averse, and will therefore be concerned to avoid buying a good that is unfair. This means that he or she will need a high p to buy the South good.

Like Adriani and Becchetti (2004:12), I assume that North individuals' income does not depend on whether the good x is produced in the North.[105] In my model, each North individual can receive the wage w_N in some sector of the economy. If the production of x changes, the individuals' labour is (frictionlessly) reallocated to or from other sectors from the economy, while total labour demand in the North is always constant, so that an individual will always work the same number H of hours. In addition to wage income, North individuals receive an equal share π of the profits from North firms. Also profits are assumed to remain unchanged with changes in x, as the other sectors adjust their output equivalently. Income for a North individual is therefore

$$W_N = w_N H + \pi \tag{5.4}$$

All income is spent on good x, so the budget constraint is

$$q = \frac{W_N}{P_i} \qquad i = N, S, F, U \tag{5.5}$$

The subscript N denotes North, S denotes the South product without fair labelling, F denotes the fair South product and U the unfair South product. Like in Adriani and Becchetti (2004:10), the indirect utility function for consumer α is

$$U(p; W_N; \alpha) = \left(\frac{W_N}{P_N} \right)^{1-\alpha} \tag{5.6}$$

if he consumes the North product,

[105] This assumption is unrealistic, and has implications for the analysis of welfare in the North. In practice, North workers may experience both reduced income and/or costs of retraining after losing their jobs to the South. See e.g. Kapstein (2000). Still, the assumption corresponds to the idea that North workers have better outside options than South workers.

$$U(p;W_N;\alpha) = \left(\frac{W_N}{P_U}\right)^{1-\alpha} (\theta\rho)^{\alpha} \tag{5.7}$$

if he consumes the unfair South product, and

$$U(p;W_N;\alpha) = \left(\frac{W_N}{P_F}\right)^{1-\alpha} \theta^{\alpha} \tag{5.8}$$

if he consumes the fair South product. For equal prices, and given $\rho\theta < 1$, all consumers prefer a fair South product. Fair goods therefore receive a higher price, i.e.

$$P_F > P_U \tag{5.9}$$

As Adriani and Becchetti (2004:11) note, since the North product is strictly preferred to an unfair South product for equal prices, we must have

$$P_U < P_N \tag{5.10}$$

As will be justified below, I assume for simplicity, like Adriani and Becchetti (2004), that we will have

$$P_F = P_N \tag{5.11}$$

If there is no ethical labelling, the consumer who buys the “Made in South” product has the expected indirect utility

$$EU_S(p;W_N;\alpha) = \left(\frac{W_N}{P_S}\right)^{1-\alpha} \theta^{\alpha}(p+(1-p)\rho^{\alpha}) \tag{5.12}$$

If p is close to one, the expected indirect utility will be close to that from consuming a fair South product.[106] If p instead is close to zero, the expected indirect utility will be close to that from consuming an unfair South product. For a p closer to the middle of the (0,1) interval, the indirect utility will also be somewhere in between. I will usually assume that the "Made in South" good receives a price which is somewhere between the prices of the fair and the unfair South goods, i.e.

$$P_F > P_S > P_U \tag{5.13}$$

Without ethical labelling, there will (normally) be a consumer indifferent between consuming the North good and the unlabelled South good. Denote this consumer by α_s.[107]

$$\alpha_s \text{ s. t. } \left(\frac{W_N}{P_S}\right)^{1-\alpha_S} \theta^{\alpha_S}(p+(1-p)\rho^{\alpha_S}) = \left(\frac{W_N}{P_N}\right)^{1-\alpha_S} \tag{5.14}$$

From this we see that the lower is ρ and/or p, the more consumers will choose to buy the North product to avoid ethical risk. Welfare in the North without ethical labelling, denoted by N^R, is (the superscript R is for "risk", i.e. ethical risk)

$$N^R = \int_0^{\alpha_S} \left(\frac{W_N}{P_S}\right)^{1-\alpha} \theta^{\alpha}(p+(1-p)\rho^{\alpha})d\alpha + \int_{\alpha_S}^{1} \left(\frac{W_N}{P_N}\right)^{1-\alpha} d\alpha \tag{5.15}$$

For low α consumers, the quantity consumed of the good is more important than its fairness. The first part of the expression is the welfare of consumers that buy ethically risky products from the South (up to consumer α_s). The second part is the welfare of consumers who buy the product from the North (the rest of the (0,1) segment).

5.1.2 Production in the North and in the South

While I have followed Adriani and Becchetti (2002, 2004) in modelling the consumer side, the production side in my model is different. As discussed in section 2.5, Adriani and

[106] Interestingly, if $p = 1$ the fair production component of preferences is "latent", but does not influence actual consumption decisions, since consumers believe that everything is OK.
[107] This consumer is somewhere in the interval (0,1), possibly at one of the endpoints.

Becchetti assume that there are two firms, a monopsonist and a fair firm. I here abstract from problems of monopsony. As such problems are emphasized by a lot of the earlier work on Fairtrade, this is an important limitation. On the other hand, I believe that my set-up is able to highlight some other important factors. One of these is the effect of the extent of extra willingness to pay for fair production among North consumers. In Adriani and Becchetti (2004), the price premium for fair products may *never* become high enough to induce the monopsonist to produce a fair product. The reason is that the constant returns to scale set-up used does not allow for positive profits in the long run, so the only way the monopsonist can make positive profits is by producing an unfair good. He therefore produces an unfair good, except when he is forced to pay the competitive wage to attract any workers at all. In addition, in Adriani and Becchetti (2004) the Fairtrade price premium does not affect the size that the fair firm may take. However, I here want to study how the size of the fairness premium affects the general conditions for fair production. In particular, if the fair price premium is high enough, *and* markets are functioning, I see no reason why *all* production in the South cannot be fair.

This leads me to the following model of the production side. First, I use the assumption of Adriani and Becchetti (2004:9) that production technologies per se are equal in the North and the South.[108] I treat North and South production together. To allow for positive profits in the long run, I use a technology with decreasing returns to scale. Firms have the choice between fair or unfair production. In this model, fairness means paying an exogenously given and constant "fair" wage. Note that unlike Adriani and Becchetti (2004:13) I do not constrain fair firms to have zero profits.[109]

The fair wage is assumed to be higher than the "market" wage, which means that fair production has higher costs than unfair production. It is not clear that this must always be the case. For example, companies will often wish to treat their workers well in order to build a motivated and productive workforce, and ensure stability.[110] However, judging from the fact that in other cases conditions for the workers seem to have been improved only after outside pressure, it seems reasonable to assume that fair production often means higher costs.[111]

As mentioned, firms in the North are *constrained* to produce in a fair manner. One might think of a "fair" wage institutionalized through minimum wage legislation. On the other

[108] This assumption is unrealistic. North firms in reality are more productive, which might give more "room" for fair production. Also, North firms (i.e. multinational companies) established in the South may be able to pay higher wages than local firms exactly because they are more productive. See Snoen (2004:128).
[109] A fair firm required to have zero profits has some similarity with what Yunus (2006) called *social businesses*.
[110] See Snoen (2004:128).
[111] See e.g. Clouder and Harrison (2005).

hand, such legislation does not exist (or is not implemented) in the South, which means that South firms have the option of producing unfairly. However, I will in much of the discussion assume that there exists a fair firm, which is *constrained* to produce a fair good, by the idealism of its board, owners, or for other reasons. This firm produces a fair good even when it does not receive the fair price. However, the fair firm is not allowed to have negative profits. This means that if the price it receives is too low, the fair firm exits the market.

Labour (L) is the only factor of production. North and South firms are price takers in the North market for good x. The production function, displaying decreasing returns to scale, is given by

$$X_i = G(L_i) \qquad i = F, U, N \qquad G' > 0, \qquad G'' < 0 \tag{5.16}$$

X_i is production and L_i is the use of labour, where the subscripts F, U and N denote a fair South, an unfair South, and a North firm respectively. Profits of a North firm are

$$\Pi_N = P_N G(L_N) - w_N L_N \tag{5.17}$$

Given an interior solution, Northern firms' optimal labour demand follows from the first order condition

$$P_N G'(L_N) = w_N \tag{5.18}$$

Profits of a fair South firm and an unfair South firm are, respectively,

$$\Pi_F = P_F G(L_F) - w_F L_F \tag{5.19}$$

$$\Pi_U = P_U G(L_U) - w_U L_U \tag{5.20}$$

Given an interior solution, fair and unfair firms' optimal labour demand follow from the first order condition with respect to the use of labour (the superscript L denotes the optimal choice when there is ethical labelling):

$$P_F G'(L_F^L) = w_F \tag{5.21}$$

$$P_U G'(L_U^L) = w_U \tag{5.22}$$

The level of production, profits and demand for labour of the two types of firms depend on prices and costs for the two types of production. Normally the demand of labour of the fair firm will not be high enough for all workers to get a job there, so that jobs in the fair firms are *rationed*. I assume South labour is homogenous, so that this rationing is not based on differences in productivity, but is a lottery.[112] The rest of the workers approach the unfair firm. As will be discussed below, usually some of these will not get a job, and go to the informal sector.

What prices each type of firm receives for their goods depend on what information consumers have about production conditions. With fair labelling, consumers are able to differentiate between goods from the two types of firms. While the fair firms always produce in a fair manner, the profit-maximizing firms choose the production technology that gives the highest profits. That is, they compare the profits resulting from the optimal production choices for fair and unfair production, respectively[113]

$$\prod_F^L = P_F G(L_F^L) - w_F L_F^L \tag{5.23}$$

$$\prod_U^L = P_U G(L_U^L) - w_U L_U^L \tag{5.24}$$

For given costs for fair production relative to unfair production, if the fair price is sufficiently higher than the unfair price, also profit-maximizing firms will choose fair production. If this is the case, I will say consumer fairness is *high*. If there is some fairness, but not enough to make fair production absolutely more profitable, I shall say fairness is *intermediate*. Note however, that this definition is relative to a given difference in costs between fair and unfair production. This means for instance that if this difference is very small, consumer fairness

[112] This assumption might not be innocuous. For example, Maurseth (2004) argues that multinational companies based in developing countries, by paying higher wages, may be able to attract the most productive labour.

[113] I assume that also profit-maximizing firms receive this price if they produce a fair good. Consumers then only care about whether the good is fair or not, and are not interested e.g. in the firms' underlying motivations, whether other goods the firm is possibly producing are fair, etc. In practice, however, some consumers care also about this. It has for instance caused controversy that the company Nescafé, target of long-standing consumer boycotts, has launched a Fairtrade certified brand. See Ransom (2005).

does not have to be very high in absolute terms. Thus, the difference in costs decides how high fairness is necessary to make fair production most profitable.

The situation without labelling

Consider now that without fair labelling consumers are not able to distinguish between fair and unfair goods. Then fair and unfair firms sell their products in *a common market* for goods labelled "Made in South", where the goods are assumed to be perfectly homogenous for the consumers, and receive the same price P_S.

The first order conditions for the two types of firms when there is no ethical labelling are then

$$P_S G'(L_F^R) = w_F \tag{5.25}$$

$$P_S G'(L_U^R) = w_U \tag{5.26}$$

Comparing these with (5.21) and (5.22) above, we see that the fair firm will have a lower level of production compared to under fair labelling, while the unfair firm will produce more. This is seen by setting e.g. for the fair firm

$$P_S G'(L_F^R) = w_F = P_F G'(L_F^L) \tag{5.27}$$

Since from (5.13)

$$P_F > P_S$$

we must have

$$G'(L_F^R) > G'(L_F^L) \tag{5.28}$$

which implies

$$L_F^L > L_F^R \tag{5.29}$$

A similar argument can be made for the unfair firm, but with the reverse sign. The fair firm also has lower profits. Compared to the situation with full information, the fair firm therefore loses while the unfair firm gains. A way of seeing this is that the unfair firm has *private information* regarding its conditions of production, which allows the firm to capture a rent at the expense of fair firms and the fair consumers.

As long as fair production is more costly than unfair production, no profit-maximizing firm will choose fair production in the situation without fair labelling. This is even so if consumers believe that all production in the South is fair and are therefore willing to pay the fair price. Indeed, this is the most fortunate situation for the unfair firm, since it then receives the fair price while only paying the costs for unfair production.

Firms' signalling of their fairness

From the above a natural question is why the fair firms do not signal their fairness directly to consumers. As mentioned in section 4.6 in reality firms often do exactly this, e.g. through own "fair" brands. However, also an unfair firm has the incentive to pretend that its goods are fair, since it will then receive the higher fair price for its products.[114] As independent fair labelling in this model is the only source of information, consumers cannot know whether a particular firm is fair or not. Therefore, we can also interpret p as consumers' subjective probability that a product labelled "fair", is in fact fair.[115]

The profits from South firms

I assume that neither North consumers nor South workers receive the profits from the two types of South firms. As far as South workers are concerned, I find the assumption reasonable.[116] It leaves the picture of welfare in the South incomplete, but reflects the idea that the owners of the firms receive the most of the gains.[117] As for North consumers, it could be interesting to assume that these also receive profits from South firms through shares in transnational companies. In this case they are possibly also *ethical investors*. But also ethical investors need ethical information, and it might be implausible to assume that such

[114] This is of course a cynical view of firms, but follows from the assumption of profit-maximization.
[115] Some implications of this are discussed in section 5.6 below.
[116] However, a fair firm might distribute some of its profits to workers.
[117] See e.g. Klein (2000), Ransom (2001) and Gaarder (2004).

information is available to North individuals as investors, but not as consumers. For the moment, I just assume that a third group outside the model receives the South firms' profits.[118]

5.1.3 Individuals in the South

Disregarding ethical concerns, South production of the good x is a perfect substitute for North production. However, like in Adriani and Becchetti (2004:9), x is not consumed in the South, and South individuals instead consume an internationally traded good y. I assume that the fairness of y is not an issue, so that only the quantity consumed of the good enters in South individuals' utility functions. Normalizing the price of y to 1, we have simply

$$U(y) = y \qquad (5.30)$$

The labour supply of South individuals is based on a Harris-Todaro framework for migration.[119] Migration from the rural areas to the urban areas occurs until the expected wage in the city is equal to the rural wage. The expected wage in the city is a probability-weighted average (i.e. shares of the urban population) of the wages in the fair firm, in the unfair firm, and the income in the urban informal sector. In the analysis, I assume that migration has stopped, and that the urban population is therefore given. However, in practice we must expect increased migration if the urban expected wage increases, which may be one result of fair labelling.

As mentioned, the allocation of workers to the two types of firms is not based on differences in worker productivity, but is a lottery. Since w_F is highest, workers go to the fair firm until it has satisfied its demand for labour.[120] The rest of the workers approach the profit-maximizing firms. w_U can here be taken as the "market" wage. However, I assume that this wage does not equalize demand for labour in the unfair firms and the residual supply of labour. The reason is that the firm, since it cannot monitor worker effort perfectly, needs to pay workers a higher wage to motivate them to put in the desired effort (*efficiency wages*). By paying a higher wage than the workers' alternatives, the firm ensures worker effort because it

[118] I return to this when I discuss public ethical investment in section 5.5 below.
[119] See Bardhan and Udry (1999:50-3)
[120] In reality, both workers' information about firms' wages and their mobility between firms could be limited. However, I disregard these complications here.

will be more costly for workers to lose their job.[121] This also means that a share of the urban workforce will not be able to get a regular job. These will work in the informal sector with a low income, which I for simplicity will set equal to zero.

The indirect utility of a South worker in a fair firm and an unfair firm, respectively, are

$$U_F(w_F) = w_F \tag{5.31}$$

$$U_U(w_U) = w_U \tag{5.32}$$

For simplicity, I assume that w_U is unchanged in the course of the analysis. However, it might be endogenous e.g. to the size of the urban informal sector and to the number of workers in the fair firm.

As L_F workers work in fair firms and L_U work in unfair firms, and with the income in the informal sector set equal to zero, aggregate welfare in the South without ethical labelling (the superscript *R* denoting "risk") can be written as

$$S^R = w_F L_F^R + w_U L_U^R \tag{5.33}$$

Welfare in the South is increasing in employment both in fair and unfair firms. However, a given increase in employment will increase welfare more if it comes in a fair firm.

5.2 Public policy 1: Ethical labelling of all goods from the South

The first public strategy we consider is labelling of all goods from the South with respect to the fairness in their production.

5.2.1 Welfare in the South

The results are summed up in table 5.1 and explained in the following.

[121] See Moene (2005). Note that I do not incorporate some other important features of Moene's model, among these demand linkages between the formal and the informal sector.

<table>
<tr><td rowspan="3">Consumer fairness</td><td colspan="3">Producer side in the South</td></tr>
<tr><td rowspan="2">Ex ante fair firms in the market</td><td colspan="2">Ex ante no fair firms in the market</td></tr>
<tr><td>Fair firm enters market</td><td>Fair firm does not enter market</td></tr>
<tr><td>No fairness</td><td>No effects</td><td>No effects</td><td>No effects</td></tr>
<tr><td>Intermediate fairness</td><td>Positive for new workers in fair firm

Negative for workers who go from unfair firm to informal sector</td><td>Positive for new workers in fair firm

Negative for workers who go from unfair firm to informal sector</td><td>Negative for workers who go from unfair firm to informal sector</td></tr>
<tr><td>High fairness</td><td>Positive for all workers (except possibly some workers who lose their job in profit-maximizing firm)</td><td>Positive for all workers (except possibly some workers who lose their job in profit-maximizing firm)</td><td>Positive for all workers (except possibly some workers who lose their job in profit-maximizing firm)</td></tr>
</table>

Table 5.1 Welfare effects in the South from ethical labelling

No consumer fairness

We look first at the case with no consumer fairness. No fairness in this context means that consumers only care about the quantity of the good. This means relaxing the assumption that $\theta\rho < 1$, and instead allowing $\theta\rho = 1$. Consumers are now indifferent between North and South goods, as long as the price is the same. Consumers have no extra willingness to pay for the possibility that a South product is fair. Therefore, the South good without ethical labelling will not receive a higher price than would an unfair good. This means that both consumers' p and ethical labelling are irrelevant.

Intermediate consumer fairness

In this case, consumers have some fairness (i.e. $\rho < 1$ and $\theta\rho < 1$). However, this fairness is not high enough to make fair production absolutely more profitable. In this case, the results depend on consumers' p and on whether there are ex ante fair firms in the South. The subcases are as follows.

Ex ante fair firms in the South market

Introducing ethical labelling will normally mean that the fair firms get a higher price for their products, while the unfair firms get a lower price. This means that fair firms will increase their production while unfair firms will reduce their production. Fair firms will increase their demand for labour, so that more workers are now able to get a job in a fair firm.

On the other hand, ethical labelling will also mean that the unfair firm receives a lower price for its product in the North. It will therefore produce less, and its demand for labour will go down. This means that some of its workers lose their job and end up in the informal sector. Formally, welfare in the South with ethical labelling is

$$S^L = w_F L_F^L + w_U L_U^L \tag{5.34}$$

To see the effects on welfare of ethical labelling in this situation we can subtract (5.33) from (5.34), which gives

$$S^L - S^R = w_F L_F^L + w_U L_U^L - w_F L_F^R - w_U L_U^R$$

or

$$S^L - S^R = w_F (L_F^L - L_F^R) + w_U (L_U^L - L_U^R) \tag{5.35}$$

Using (5.29) above, the first term is positive, and represents the increased welfare of the workers who are now able to get a job in a fair firm. By a similar argument for the unfair firm, but with the reverse sign, the second term is negative (assuming w_U is constant), since some workers in the unfair firms lose their job and have to go to the informal sector.

How large this effect is for the two firms, depends on how large is the difference between the price of the South good without ethical labelling, and the prices for the fair and the unfair good, respectively. The importance of *p* here comes through its effect on the price of the South good without ethical labelling. If *p* was very high, consumers trusted that most South products were fair, and the unlabelled South good received a high price. The effect in terms on increased price for the fair firm from ethical labelling are then not so large, and its demand for labour is not increased so much. On the other hand, the unfair firm will receive a much lower price when it can no longer benefit from high consumer trust. Its production and demand for labour will therefore be reduced significantly.

Thus, for a given level of consumer fairness, the lower is p, the more the South has to gain from ethical labelling (as long as there is ex post a fair South alternative available to North consumers). Assume for example that $p = 0$, but that in reality there are fair firms. Then ethical labelling will show ethical consumers that there are fair firms, and these will now receive a higher far price for their products and can employ more workers. Also, since the South good without ethical labelling did not receive a higher price than the unfair product, unfair firms' production and demand for labour will be unaffected, so that no one will be worse off in this case.

At the other extreme, if $p = 1$, consumers thought all South products were fair, and were willing to pay the fair price for all South products. Fair firms will then not receive a higher price with ethical labelling than without, and there are no positive effects. At the same time, unfair South firms who used to receive the fair price will now only receive the unfair price, which will give a large reduction in production and hence employment.

Ex ante no fair firms in the South market

If there are ex ante no fair firms in the South market, and only intermediate consumer fairness, the model says that ethical labelling *can* be harmful for the South, for a p larger than zero. North consumers were then too "optimistic", and believed mistakenly that a share of the products from the South were fair. Ethical labelling will lead some consumers to switch from South products to North products, as they know that North products are fair. This may be understood as a *boycott* (in a narrow sense) of unfair South products. Since the unfair South firms now receive a lower price for their products, they will export less. This will lead to reduced demand for labour, and the number of employed South workers decreases. With the superscript LN denoting the case with no fair alternative,

$$L_U^{LN} < L_U^R \tag{5.36}$$

There are now only negative effects on welfare in the South[122]

[122] This result resembles the result in Adriani and Becchetti (2004:20) that in the absence of fair production, North consumers' preferences for fairness are harmful to welfare in the South. While actual boycotts will have negative effects in the short run, a credible *threat* of boycotts could have the effect of leading firms to choose fair production. See Innes (2006) for a theoretical perspective. Also, a boycott of one firm may "scare" other firms. See Clouder and Harrison (2005:99). However, I will not discuss this further here.

$$S^{LN} - S^{R} = w_U (L_U^{LN} - L_U^{R}) \tag{5.37}$$

In fact, welfare in this case would be higher if consumers had no preferences for fair production.

However, there is one situation where this result does not hold. As we remember, fair firms need a certain price in order to be able to stay in the market. Denote this price as P_{MIN}. With intermediate fairness the fair price will be higher than the price for the good labelled "Made in South". This means that we could have the following relationship between prices:

$$P_S < P_{MIN} < P_F \tag{5.38}$$

In this case, the higher fair price enables fair firms to enter the market. The effects will then be the similar as in the case when there is ex ante a fair firm in the market.

More generally, in my model the result that consumer fairness is harmful in the ex ante absence of fair firms in the South is true only for *intermediate* levels of fairness. The reason is that high fairness in this model makes fair production absolutely more profitable, which means that profit-maximizing firms will change to fair production.

High fairness

Suppose now that consumer fairness in the North is so high that fair production becomes absolutely more profitable. For a given relationship between the costs of fair and unfair production, I will then say consumer fairness is *high*. In this case it does not matter whether there is ex ante fair firm in the South. This is because high consumer fairness will mean that profit-maximizing firms realize that fair production is absolutely more profitable, and they will therefore change to fair production.[123] The consumers now have only a fair alternative. The effects on welfare are now (LO denotes L for "Labelling" and O for "Only fair good", while the subscript P denotes profit-maximizing firms producing in a fair manner.)

$$S^{LO} - S^{R} = w_F L_F^{LO} + w_F L_P^{LO} - w_F L_F^{R} - w_U L_U^{R}$$

[123] That firms should know this is a strong assumption, especially if they have not observed a choice between fair and unfair products. It is probably more realistic to assume that firms are uncertain about consumer fairness. This might weaken the conclusion that strong consumer fairness is a sufficient condition.

$$= w_F(L_F^{LO} - L_F^R) + w_F L_P^{LO} - w_U L_U^R \tag{5.39}$$

The first term in this expression is the increased welfare of the workers that find employment in a fair firm. The two last terms contain two effects. On the one hand, the increased wage for workers, and on the other hand the effects on employment in the profit-maximizing firm from changing to fair production. There are two effects on employment which pull in opposite directions. The higher fair product price means that the firm would like to increase output and therefore employment. However, the higher factor price means that firms would like to reduce the use of the factor. We cannot be sure which of these two effects will be the strongest.

If the net effect on labour demand is non-negative, the effects can be illustrated more clearly by adding and subtracting $w_F L_U^R$

$$S^{LO} - S^R = w_F(L_F^{LO} - L_F^R) + (w_F - w_U)L_U^R + w_F(L_P^{LO} - L_U^R) \tag{5.40}$$

The first term is the same as above. The second term is the increased welfare of the workers who were already in the unfair firm and now have higher wages. The third term is either zero or positive, depending on whether the net effects on employment in the profit-maximizing firm are zero or positive. If they are positive, the third term represents the increased welfare of workers who go from the informal sector to a job in the profit-maximizing firm for a fair wage.

If the net effect on labour demand is negative, we instead add and subtract $w_U N_P^{LO}$ to get

$$S^{LO} - S^R = w_F(L_F^{LO} - L_F^R) + (w_F - w_U)L_P^{LO} + w_U(L_P^{LO} - L_U^R) \tag{5.41}$$

The second term now is the increased welfare through higher wages of a smaller number of workers who stay in the profit-maximizing firm. The third term, however, is negative and represents the reduced income of workers who lose their job in the profit-maximizing firm.

We note from this that in this model a *sufficient* condition for all regular production to be fair, is that North consumers' "aggregate" fairness is high enough. Note also that in this situation the "market" wage and the minimum "fair" wage are the same. However, it is possible that some workers will lose their job because of reduced labour demand in the profit-maximizing firm, and in any case normally some workers will still be left in the informal sector.

5.2.2 Welfare in the North

The welfare analysis for North consumers follows the lines of Adriani and Becchetti (2004). The results are summed up in table 5.2.

Consumer fairness	**Producer side in the South**		
	Ex ante fair firms in the market	Ex ante no fair firms in the market	
		Fair firm enters market	No fair firm enters market
No fairness	*No effects*	*No effects*	*No effects*
Intermediate fairness	*Positive for all consumers*	*Positive for all consumers*	*Negative for most consumers* *Possibly positive for least fair consumers*
High fairness	*Positive for consumers who switch to fair product* *Negative for least fair consumers*	*Positive for consumers who switch to fair product* *Negative for least fair consumers*	*Positive for consumers who switch to fair product* *Negative for least fair consumers*

Table 5.2 Welfare effects in the North from ethical labelling

No fairness

Also when it comes to North consumers, this case is particularly simple. If no North consumers care about fairness, neither their p nor ethical labelling is relevant.

Intermediate fairness

The welfare effects for North consumers depend on whether there is ex ante a fair alternative in the South. First, for $P_F = P_N$, the fair South product is strictly preferred to the North product, and the North product will be out of the market. To make the analysis simpler, and since it does not affect the main conclusions, I will henceforth assume that this is what happens when ethical labelling is introduced. This then justifies (5.11).

Ethical labelling now leads the North consumers who were consuming the North product to switch to the fair South product. Also some of the consumers that consumed the "Made in South" good switch to the fair product, while the remaining consumers buy the unfair South product. The fair South product receives a higher price than the South product without ethical labelling, while the unfair South product receives a lower price. With αU denoting the consumer indifferent between an unfair and a fair South product, and using $P_F = P_N$, welfare in the North is now

$$N^L = \int_0^{\alpha_U} \left(\frac{W_N}{P_U} \right)^{1-\alpha} (\theta\rho)^\alpha d\alpha + \int_{\alpha_U}^{1} \left(\frac{W_N}{P_N} \right)^{1-\alpha} \theta^\alpha d\alpha \tag{5.42}$$

We compare this with expression (5.15), which is given again for convenience:

$$N^R = \int_0^{\alpha_S} \left(\frac{W_N}{P_S} \right)^{1-\alpha} \theta^\alpha (p + (1-p)\rho^\alpha) d\alpha + \int_{\alpha_S}^{1} \left(\frac{W_N}{P_N} \right)^{1-\alpha} d\alpha$$

Consumers in the North fall into three categories. First, the consumers who used to consume the North product, but switch to the fair South product, must be better off. Now they can consume South goods without ethical risk. Second, the consumers who prefer to consume an unfair South product will also be better off because they can now get the South product for a lower price, and thus consume a larger quantity. Finally, the consumers who were previously consuming the ethically risky South product and are now consuming the fair South product must be better off by revealed preference. They could get an unfair South good for a lower price than the South good without ethical labelling, but they still choose to consume the fair South good.

If there is ex ante no fair firm in the South, fair labelling may lead to reduced welfare also in the North. Some consumers switch to consuming North products, while some keep on consuming the unfair South product. With α_{UN} denoting the consumer indifferent between the North good and the unfair South good, welfare in the North is

$$N^{LN} = \int_{0}^{\alpha_{UN}} \left(\frac{W_N}{P_U} \right)^{1-\alpha} (\theta\rho)^{\alpha} d\alpha + \int_{\alpha_{UN}}^{1} \left(\frac{W_N}{P_N} \right)^{1-\alpha} d\alpha \qquad (5.43)$$

The consumers who switch to the North product must be worse off after ethical labelling, since their welfare from consuming the ethically risky South product was higher than that from consuming the North product.[124] This effect is stronger the higher was p. For consumers who keep on consuming the South product, the effect is unclear. On the one hand, some of them had a higher welfare from consuming an ethically risky South product than an unfair South product. On the other hand, the price of the unfair South product is now lower. This means that the consumers who are least concerned with fairness must be better off. Also this effect is stronger the higher was p, since the greater will be the reduction in the price of the South good.

However, if the higher fair price allows fair firms to enter the market (see (5.38) above), effects are as in the situation when there ex ante are fair firms in the South.

High fairness

As discussed above, with high fairness it does not matter whether there is ex ante a fair alternative or not. The only alternative will be the fair South product. With the superscript *LO* denoting the case with only the fair alternative, welfare is

$$N^{LO} = \int_{0}^{1} \left(\frac{W_N}{P_N} \right)^{1-\alpha} \theta^{\alpha} \qquad (5.44)$$

When there is only a fair good, α_S is not determined.[125] But note that (5.44) can be written as[126]

$$N^{LO} = \int_{0}^{\alpha_S} \left(\frac{W_N}{P_N} \right)^{1-\alpha} \theta^{\alpha} d\alpha + \int_{\alpha_S}^{1} \left(\frac{W_N}{P_N} \right)^{1-\alpha} \theta^{\alpha} d\alpha \qquad (5.45)$$

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[124] “Ignorance is bliss”.
[125] See Adriani and Becchetti (2004:17).
[126] See Adriani and Becchetti (2004:19-20).

We can now write the difference between (5.45) and the welfare without ethical labelling as

$$N^{LO} - N^{R} = \int_{0}^{\alpha_S} \left[\left(\frac{W_N}{P_N} \right)^{1-\alpha} \theta^{\alpha} - \left(\frac{W_N}{P_S} \right)^{1-\alpha} \theta^{\alpha} (p + (1-p)\rho^{\alpha}) \right] d\alpha$$

$$+ \int_{\alpha_S}^{1} \left[\left(\theta^{\alpha} - 1 \right) \left(\frac{W_N}{P_N} \right)^{1-\alpha} \right] d\alpha \qquad (5.46)$$

The second term is positive (assuming $\theta > 1$) and represents the welfare improvement for the consumers that are most concerned with fairness. Since average consumer fairness is very high in this case, one would think that most consumers are better off. However, the first term is not necessarily positive, as the consumers that are mainly concerned with the quantity of the good have to pay a higher price for the good than before, and will therefore be able to afford less of it.

5.3 Public policy 2: Ensure a fair alternative

The interest of this second public policy arises from two observations. First, we saw in the analysis of ethical labelling above that for intermediate consumer fairness, fair labelling will be harmful for the South if there is ex post no fair alternative. We also saw that if there is a fair alternative, ethical labelling will lead some consumers to start consuming fair South products, while others will consume unfair products. For the latter group, who do not care (sufficiently) about fairness in production, ethical labelling is not relevant. One could therefore argue that *rather than ethical labelling as such, the existence of a fair alternative is the public good we should be concerned about*. Instead of labelling all goods, a better strategy for the authorities might therefore be to ensure that there is a fair alternative. The authorities can e.g. offer firms to certify their products as fair, given that they satisfy the criteria for fair production. Fair firms will seize this opportunity. The profit-maximizing firms will also want their products certified if fair production is more profitable, because the certification will enable them to charge the fair price. If there are ex ante no fair firms and fair production is not absolutely more profitable, the authorities might have to find other ways to ensure a fair alternative in the market.[127]

The welfare implications of this can be studied by introducing a fair alternative in the situation where there is only the product labelled “Made in South”. The consumers can now choose between two products from the South: One that is labelled fair, and one that is not labelled.

5.3.1 Welfare in the South

The results are summed up in table 5.3. Note how this table differs from 5.1 and 5.2 by the fact that there is now always a fair alternative. Instead, the effects now depend on whether p changes or not.

Consumer fairness	**Consumer beliefs about fairness in the South**	
	p unchanged	p reduced
No fairness	*No effects*	*No effects*
Intermediate fairness	*Positive for new workers in fair firm* *Unchanged for other workers*	*Positive for new workers in fair firm* *Negative for workers who go from unfair firm to informal sector*
High fairness	*Positive for all workers (except possibly negative for some workers who lose their job in profit-maximizing firm)*	*Positive for all workers (except possibly negative for some workers who lose their job in profit-maximizing firm)*

Table 5.3 Welfare effects in the South from guaranteeing a fair alternative

No fairness

Also here, the case with no consumer fairness is simple: As long as its price is higher, no consumers will choose the fair product.

Intermediate fairness

The consumers that are most concerned with fairness will switch from the North good to the fair South good, as will some of the consumers that were consuming the unlabelled South

[127] One possibility, public ethical investment, is discussed below.

good. The least fair consumers, on the other hand, will continue consuming the unlabelled South good, since this is cheapest. However, the effects also depend on whether consumers' *p* for the remaining South goods changes or not. If it does not, the price received by the firms that do not get the fair label will not change, and there will be no negative effects from workers losing their jobs in these firms. The effect on welfare in the South is then (*A* denotes "alternative")

$$S^{A} - S^{R} = w_{F}(L_{F}^{A} - L_{F}^{R}) \tag{5.47}$$

However, the introduction of a fair alternative could lead consumers to reduce their *p*.[128] If we e.g. have rational expectations in the sense that consumers' *p* is accurate, one must expect consumers to reduce their *p* for the remaining goods. With the superscript *AC* denoting "alternative" and "changed p", the welfare effects in the South are then

$$S^{AC} - S^{R} = w_{F}(L_{F}^{AC} - L_{F}^{R}) + w_{U}(L_{U}^{AC} - L_{U}^{R}) \tag{5.48}$$

The first term is the same as the first term in expression (5.47). The second term represents the negative effect on workers who lose their job in the profit-maximizing firms, as these now get a lower price for their product. The larger the reduction in *p*, the more important is this effect. An extreme situation is when consumers believe that all fair goods now carry the fair label. In this case their *p* for the remaining South goods is zero, and the unlabelled South good receives only the unfair price.

The accuracy of *p* is also important. First, if all fair firms are in fact labelled fair, the situation is equivalent to labelling of all products with regard to their fairness. On the other hand, if consumers get the impression that all fair firms are now certified fair, but there still are fair firms that for various reasons are not certified, introducing a fair alternative is actually welfare inferior to labelling all products.

High fairness

With high fairness, fair production will be absolutely more profitable. The fair firms will seek to have their product labelled fair, and the profit-maximizing firms will change to fair production and do the same. Since all firms sell a fair product, and there no longer will be an

[128] I consider an increased *p* to be unrealistic.

unlabelled alternative from the South, p is irrelevant. With the superscript AO denoting the situation with certification and only a fair good, and the subscript P as above denoting a profit-maximizing firm with fair production, the effects on welfare in the South are now

$$S^{AO} - S^{R} = w_F L_F^{AO} + w_F L_P^{AO} - w_F L_F^{R} - w_U L_U^{R}$$

$$= w_F (L_F^{AO} - L_F^{R}) + w_F L_P^{AO} - w_U L_U^{R} \qquad (5.49)$$

As for (5.39) above, we cannot be sure whether the net effects on the labour demand of the profit-maximizing firms are positive or negative. If they are non-negative, by adding and subtracting $w_F L_U^R$ we can write the welfare expression more communicatively as

$$S^{AO} - S^{R} = w_F (L_F^{AO} - L_F^{R}) + (w_F - w_U) L_U^{R} + w_F (L_P^{AO} - L_U^{R}) \qquad (5.50)$$

The first term is the increased welfare of new workers that are employed in the fair firms. The second term is the increased welfare of the workers who were already in the unfair firm and who now receive higher wages. The third term is the increased welfare of new workers in the profit-maximizing firm who used to be in the informal sector but who now receive the fair wage (or the unchanged welfare of workers who stay in the informal sector).

If the net effects on the labour demand of the profit-maximizing firm are negative, we instead add and subtract $w_U L_P^{AO}$ to get

$$S^{AO} - S^{R} = w_F (L_F^{AO} - L_F^{R}) + (w_F - w_U) L_P^{AO} + w_U (L_P^{AO} - L_U^{R}) \qquad (5.51)$$

The first term is the same as before. The second term now represents the increased welfare through higher wages of a smaller number of workers who stay in the fair firm. The third term is negative, and represents the reduced income of workers who lose their job in the profit-maximizing firm.

5.3.2 Welfare in the North

Results are summed up in table 5.4 and explained below.

No consumer fairness

The fair alternative will be irrelevant for consumers who are unconcerned with fairness.

Consumer fairness	**Consumer beliefs about fairness in the South**	
	p unchanged	*p* reduced
No fairness	*No effects*	*No effects*
Intermediate fairness	*Positive for consumers who switch to the fair product* *Unchanged for other consumers*	*Positive for consumers who switch to the fair product* *Possibly positive for consumers who continue consuming South product*
High fairness	*Positive for consumers who switch to the fair product* *Unchanged for least concerned consumers*	*Positive for consumers who switch to the fair product* *Possibly negative for least concerned consumers*

Table 5.4 Welfare effects in the North from guaranteeing a fair alternative

Intermediate fairness

I assume that North production of the good ceases. With αA denoting the consumer indifferent between consuming the fair South good and the “Made in South” good, welfare in the North is

$$N^{A} = \int_{0}^{\alpha_A} \left(\frac{W_N}{P_S}\right)^{1-\alpha} \theta^{\alpha}(p+(1-p)\rho^{\alpha})d\alpha + \int_{\alpha_A}^{1} \left(\frac{W_N}{P_N}\right)^{1-\alpha} \theta^{\alpha} d\alpha \qquad (5.52)$$

Again we compare with (5.11)

$$N^{R} = \int_{0}^{\alpha_S} \left(\frac{W_N}{P_S}\right)^{1-\alpha} \theta^{\alpha}(p+(1-p)\rho^{\alpha})d\alpha + \int_{\alpha_S}^{1} \left(\frac{W_N}{P_N}\right)^{1-\alpha} d\alpha$$

Consumers fall into three categories. First, the consumers who used to consume the North product, but switch to consuming the fair South product, are better off, as they can now consume South goods without ethical risk. For the consumers who continue to consume the “Made in South” product effects depend on whether p changes or not. If p is unchanged, the price of the good is unchanged and also their welfare. If p changes effects might be unclear for some consumers. On the one hand, the price of the good is lower, but on the other hand ethical risk increases. However, for the consumers who are mainly concerned with the quantity of the good, the increased ethical risk will be less important than the lower price. Finally, consumers who were previously consuming the “Made in South” good and are now consuming the fair South product are better off by revealed preference. This is because they could consume the “Made in South” good for a lower price than before, but choose the fair South good.

High fairness

With high fairness, there will be only fair goods in the market. In this case, the results are the same as for fair labelling of all South products.

5.4 Public policy 3: International standards

This policy differs from the policies described above. Effective international legislation means that firms in the South no longer have the option of unfair production. This amounts to requiring all South firms to pay their workers the fair wage. The authorities then go one step further than just allowing consumers to exercise consumer power by providing information and/or a fair alternative. Consumers now no longer have the choice of an unfair product. Policy-makers could have good moral reasons for disregarding consumer sovereignty here. However, despite the good intentions of the authorities, it is not clear that welfare effects will always be predominantly positive for the South.

As I have assumed that fair production is more costly, international standards will lead production costs to increase in all previously unfair firms. The welfare effects depend on the fairness and *information* of North consumers. I will here distinguish between two cases: One case in which North consumers are aware of the existence of international standards, and one case where they are not.

5.4.1 Welfare in the South

See table 5.5 for a summary. Note again how this table differs from the previous ones; in this case consumer information about the standards may be crucial for the results.

Consumer fairness	**Consumer information about international standards**	
	Informed	Uninformed
No fairness	*Positive for workers in unfair firms who get higher wages* *Negative for workers who go from unfair firm to informal sector*	*Positive for workers in unfair firms who get higher wages* *Negative for workers who go from unfair firm to informal sector*
Intermediate fairness	*Positive for new workers in fair firm* *Positive for workers in unfair firms who get higher wages* *Negative for workers who go from unfair firm to informal sector (but these are fewer when consumers are informed)*	*Positive for workers in unfair firms who get higher wages* *Negative for workers who go from unfair firm to informal sector*
High fairness	*Same as for Public policy 1 and Public policy 2*	*Positive for workers in unfair firms who get higher wages* *Negative for workers who go from unfair firm to informal sector*

Table 5.5 Welfare effects in the South from international standards

No fairness

In this case, whether consumers have ethical information about the products or not does not matter. International standards have two effects for welfare in the South. First, they increase the welfare of some workers who previously received the unfair wage, but now receive the fair wage. However, since costs increase for the profit-maximizing firms, they will employ fewer workers, which means that a number of workers lose their job. The fair firms, on the other hand, are not affected even if consumers are informed, because there in any case is no higher willingness to pay for a fair product. Therefore, with the superscript *SN* denoting the situation with standards and no fairness,

$$L_F^{SN} = L_F^R \tag{5.53}$$

Welfare effects in the South are

$$\begin{aligned} S^{SN} - S^R &= w_F L_F^{SN} + w_F L_P^{SN} - w_F L_F^R - w_U L_U^R \\ &= w_F L_P^{SN} - w_U L_U^R \end{aligned} \tag{5.54}$$

The effects can be seen more clearly by adding and subtracting $w_U L_P^{SN}$

$$S^{SN} - S^R = (w_F - w_U) L_F^{SN} + w_U (L_P^{SN} - L_U^R) \tag{5.55}$$

The first term is the increased welfare, through higher wages, of the workers that stay in the unfair firm. The second term is the reduced welfare of the workers who lose their job in the unfair firm.

Intermediate fairness

In this case, ethical information is important. We look first at the case with informed consumers. International standards means that consumers know all goods from the South are fair. Therefore, all South goods now receive the fair price. Fair firms are then able to expand their production and employ more workers. Also, although the costs of the profit-maximizing firms increase, this is partly compensated for by a higher price for their products. Therefore, with informed consumers (the superscript *SI* denoting standards and informed consumers), welfare effects in the South are

$$S^{SI} - S^R = w_F L_F^{SI} + w_F L_P^{SI} - w_F L_F^R - w_U L_U^R \tag{5.56}$$

The effects can be seen more clearly by adding and subtracting $w_U L_P^{SI}$

$$S^{SI} - S^R = w_F (L_F^{SI} - L_F^R) + (w_F - w_U) L_P^{SI} + w_U (L_P^{SI} - L_U^R) \tag{5.57}$$

The first term is the increased welfare of the new workers that find a job in the fair firm. The second term is the increased welfare, through higher wages, of the workers who stay in the unfair firm. The last term is the reduced welfare of workers who lose their job in the unfair firm, since it reduces its demand for labour.

In the situation with uninformed consumers, on the other hand, things are different. South products will now not receive the fair price. This means that there is no positive effect through increased demand for labour in the fair firm. In addition, the profit-maximizing firm will not receive a higher price to compensate for some of the cost increase. Therefore, the demand for labour in the profit-maximizing firm will be higher in the situation with informed consumers, i.e.

$$L_P^{SI} > L_P^{SU} \tag{5.58}$$

By similar calculations as for (5.55), we find

$$S^{SU} - S^R = (w_F - w_U)L_P^{SU} + w_U(L_P^{SU} - L_U^R) \tag{5.59}$$

This situation is clearly welfare-inferior to the situation with informed consumers.

High fairness

If consumers are informed, the constraint of international standards is not binding, since fair production is in any case most profitable. Then the effects will be the same as for fair labelling or guaranteeing a fair alternative.

The case with uninformed consumers, however, is again different. In fact, even if consumer fairness is high, so that North consumers would be willing to pay for the increased costs of fair production, the lack of information now leads international standards to have a predominantly negative impact on welfare in the South. This points to the importance of information. A clear policy implication seems to be that *an introduction of international standards must be accompanied by informing North consumers that effective international standards are in place.*

5.4.2 Welfare in the North

See table 5.6 for a summary.

No fairness

When consumers are unconcerned with fairness, the effects of international standards do not depend on whether they are informed or not. In this case, the unlabelled South good is not able to get a higher price than would an unfair good. All consumers will be consuming the South good if this is cheaper than the North good. However, since the costs of South firms increase, the offer curve for products “Made in South” will shift back, and because the demand curve is downward sloping (see equation (5.5) above), some of the cost increase will be passed on to North consumers, who will be worse off.

Consumer fairness	**Consumer information about international standards**	
	Informed	Uninformed
No fairness	*Unchanged/negative for all consumers*	*Negative for all consumers*
Intermediate fairness	*Positive for most fair consumers* *Negative for least fair consumers*	*Negative for all consumers*
High fairness	*Same as for Public policy 1 and Public policy 2*	*Negative for all consumers*

Table 5.6 Welfare effects in the North from international standards

Intermediate fairness

When there is intermediate fairness, the welfare effects for consumers depend on their information. If consumers are informed, the most concerned consumers will have increased utility from knowing that the good is fair. Consumers who switch from the North good to the certified fair South goods must be better off. Also some consumers who were consuming the “Made in South” good are better off, even if the price is higher, since the product is now guaranteed fair. However, the consumers who are mainly concerned with the quantity of the good will be worse off, since the higher price means that they can consume less than before. With the superscript *SI* denoting the situation with standards and informed consumers, welfare in the North is

$$N^{SI} = \int_0^1 \left(\frac{W_N}{P_N} \right)^{1-\alpha} \theta^{\alpha} \tag{5.60}$$

By similar calculations as for (5.46) above, we find the following expression

$$N^{SI} - N^R = \int_0^{\hat{\alpha}_S} \left[\left(\frac{W_N}{P_N} \right)^{1-\alpha} \theta^{\alpha} - \left(\frac{W_N}{P_S} \right)^{1-\alpha} \theta^{\alpha}(p + (1-p)\rho^{\alpha}) \right] d\alpha$$

$$+ \int_{\hat{\alpha}_S}^1 \left[\left(\theta^{\alpha} - 1 \right) \left(\frac{W_N}{P_N} \right)^{1-\alpha} \right] d\alpha \tag{5.61}$$

Note that $\hat{\alpha}_S > \alpha_S$. This is because the number of consumers choosing the North product rather than the "Made in South" product in the situation without labelling, will be higher with high fairness than if fairness is only intermediate. This also means that the positive effects from the fact that the South product is now fair, are smaller than if fairness was high.

If consumers are not informed, they cannot derive utility from the fact that the South good is now fair. While the welfare of the consumers who were consuming the North product is unchanged, all other consumers are worse off. Some consumers will continue consuming the South good for a higher price than before, while some consumers will switch to the North good since the higher price means they are compensated less for the experienced ethical risk of consuming the South good.

High fairness

As mentioned above, if there is high consumer fairness and consumers are informed, international standards are irrelevant. Therefore welfare effects are the same as with high consumer fairness under Public policy 1 and Public policy 2.

When consumers are not informed, things are quite different. In this case, all products are fair, which should have meant that most consumers will be better off. However, since they are not aware of the standards, the increased price of the South good means that consumers' utility will *decrease*.

5.5 Public policy 4: Public ethical investment

Finally, I will just say some words about a fourth possible policy. In section 5.1.2, I opened up for the possibility of ethical investment by discussing the distribution of South firms' profits. Depending on whether ethical investors have other information than ethical consumers, ethical investment may ensure fair production where ethical consumption fails. A possible strategy for the authorities could therefore be to use its investments to ensure fair production in the firms it owns in the South. What would be the welfare effects of this?

First, as we have seen, in the model ethical investment means a redistribution of profits from the owners of the firms to the workers. The authorities, like other investors, might feel they can afford this. However, requiring fair production through ethical investment will also normally mean that the firm is able to employ fewer workers than it otherwise could have done. As in the case with international standards, the effects depend on consumers' fairness and information. If there is no consumer fairness, or consumers are not aware that the products are fair, some workers will have better conditions, while others lose their job. For intermediate fairness and informed consumers, some of the reduction in employment from higher wages will be offset by a higher price for the countries' products. Finally, if consumer fairness is high, also ethical investment is irrelevant.

5.6 Extension: Consumer trust as a public good for firms

Consumers' p will be one of the factors determining which price the unfair firm can get for its "fair" product. If consumer trust is low, this price will also be low. In section 3.2 I presented the idea of consumer trust as a public good for firms. This corresponds to p in the model. Although I have not modelled a process for the formation of p, it could be affected negatively e.g. by the number of reports in the media of bad working conditions. A profit-maximizing firm chooses fair or unfair production, knowing that if it is "caught" in unfair production, it contributes to lower consumer trust. However, the cost of lower general consumer trust is shared by all firms (also fair firms).[129] This means that the firms face a "tragedy of the commons"-problem.

However, we also saw that many firms seek to "privatize" consumer trust, in order to become less vulnerable to the bad practices of other members of their industry. As mentioned

[129] There is another interesting point to be made here. It is well known that bad news seem to get more attention than good news. Even only sporadic reports of bad working conditions in the factories of transnational companies in the South might leave consumers cynical, even if most of the time, conditions are OK. Even a very few cases of firms choosing unfair production can thus do great harm if consumers are very concerned with fairness.

this also means a privatization of risk. If the firm is caught treating its workers badly, it will see the value of its particular brand reduced. The effects are then no longer symmetrical. This supports the argument that transnational "brand" companies might be a catalyst for improved conditions in poor countries, since consumers have a brand to which they can address their concerns, rather than an entire industry, or a mass of "faceless" local producers.[130] However, this effect depends on the ability of e.g. the media and NGOs to "arrest" the companies that have unfair production (i.e. the probability of being caught).

5.7 More on public policy

Though I have concluded that the authorities might have a role to play in the provision of fair goods, this does not mean that they themselves have to produce the service.[131] Broadly, there are four ways of sharing responsibilities between the public and the private sector. One can have public financing and production; public financing, but private production; private financing and public production; and private financing and production. A possibility is public financing, but private production. It would seem natural to base the work of labelling goods on the organizations that already exist, like Fairtrade. The authorities could support financially schemes like Fairtrade to give them the resources to label also other types of goods than primary products.

An important way public authorities can support Fairtrade more generally is by public procurement of Fairtrade goods. The EU has explicitly stated as a goal to promote the use of Fairtrade products, and there are several projects in the EU supporting Fairtrade.[132] Fairtrade coffee and tea is now being sold at all parliament meetings, and Fairtrade products are sold in the cafeterias of the European Commission.[133] In appendix C I briefly present the *Fairtrade towns* campaign, which has been particularly important to fair public procurement.

By having lower duties for Fairtrade products, products produced in a fair manner could be given a competitive advantage over other products (a type of *preferential treatment*). However, it is unclear whether this would be accepted by the WTO.

[130] See Snoen (2004:142).
[131] See Hagen (2000:122).
[132] See Terragni, Jacobsen, Roos, Torjusen and Vittersø (2006:42-3).
[133] Fair Trade Advocacy Office (2005:5).

6 Conclusion

In this thesis I have studied Fairtrade and ethical consumption, with the aim of deriving broad implications for public policy. I considered two welfare aspects. First, I argued that many North consumers have altruistic preferences for the welfare of South workers, and that Fairtrade may provide these consumers with additional value. I then discussed at a general level possible welfare implications in the South of ethical consumption. On the one hand, fair consumers can promote fair production by rewarding fair firms and punishing unfair firms. On the other hand, ethical consumption can have negative effects, as in the case when a boycott causes workers to lose their job, and the job in an unfair firm after all was better than their alternative.

A first question is whether there is any need for public policy at all, or whether a private market can realize the “desired” level of Fairtrade. I have argued that there are market failures in the provision of information about the ethical characteristics of goods. The problem essentially arises from firms’ private information about their production conditions, and the fact that it is costly for consumers to search such information themselves. Consumers might therefore be sceptical about firms’ own claims to fairness. This can lead North consumers to feel ethical risk in connection with the purchases of products from the South. This problem is partly alleviated by independent, non-profit altruistic agents like Fairtrade. These certify fair products and sum up the ethical information in a simple product label, which makes ethical consumption much less costly. However, there might be limits to the resources of such altruistic agents. Even though they have been able to label simple products like coffee, labelling products with a longer and more complex production chain might be too expensive. I have therefore argued that there seems to be a need for public policy.

The second question is what type of public policy is preferable. One type of public policy is to “help” the market by providing ethical information to consumers, to allow them to choose between fair and unfair products. Another type of public policy, regulation, goes further and requires all production in the South to be fair. There is thus a contrast between policies that seek to facilitate ethical consumption, and policies that seek to regulate production itself.

I then set up a model to study the welfare effects of four possible public policies: *1*. Labelling all products from the South with respect to their fairness; *2*. Guaranteeing a fair alternative to consumers; *3*. ensuring all South products are fair through international standards; and *4*. Using public ethical investment to ensure fairness in South firms. The model incorporated North consumers' ethical risk and the few outside options of South individuals. The main mechanism in the model works through prices, with fair goods normally being able to take a higher price than unfair goods.

For *Public policy 1*, labelling all products from the South, the main results were as follows. First, if there is *no consumer fairness*, ethical labelling is irrelevant, since consumers in any case buy the cheapest products. With *intermediate fairness*, fair products receive a higher price than the price for goods "Made in South", while unfair products receive a lower price. Because they receive a higher price for their products, fair firms can expand their production and employ more workers. This leads to increased welfare for these workers. However, unfair firms will receive a lower price for their products, and some workers may lose their job and end up in the informal sector with a very low income. Therefore, some of the costs for unfair firms from being boycotted by ethical consumers are passed on to the South workers. Fair consumers in the North who are now able to buy guaranteed fair products have a higher welfare, as do the least fair consumers who can now buy a cheaper South good.

If there are ex ante no fair firms in the South market, ethical labelling may have only negative effects, since the lower price for unfair products means reduced demand for labour in the South. Also the welfare of North consumers is reduced. However, a higher fair price may allow fair firms to enter the South market. Effects are then as in the case with ex ante fair firms in the South market.

With *high fairness*, the price for fair products is sufficiently higher than the price for unfair products to make fair production most profitable. Then also profit-maximizing firms switch to fair production, and all *regular* production in the South is fair. All South workers experience a welfare improvement (except possibly some workers who lose their job in the profit-maximizing firm if the net effects on its demand from changing to fair production are negative). Also most North consumers are better off, except the least fair consumers who no longer have the option of a cheap unfair good.

Ethical labelling thus will usually have some positive and some negative effects. However, if there is ex post no fair alternative available to consumers, there are only negative effects. This means that it is important to ensure that there is a fair firm in the market. In addition, as ethical labelling is irrelevant for consumers who are not concerned with fairness, guaranteeing a fair alternative might be a more efficient way to reach ethical consumers.

Public policy 2 is guaranteeing a fair alternative. This could be done by certifying existing fair firms as fair. The main results were as follows. First, with *no fairness*, a fair alternative is irrelevant if its price is higher, since consumers in any case buy the cheapest product. With *intermediate fairness*, certified fair firms receive a higher price and are able to employ more workers. However, there might be negative effects for the workers in the unfair firm, if the fair alternative leads to consumers to reduce their probability that the non-certified products from the South are fair. This is because the non-certified South good then receives a lower price. If there are ex ante no fair firms, the authorities have to ensure a fair alternative themselves. This could be done e.g. by public ethical investment (see below). With *high fairness*, also profit-maximizing firms change to fair production and have their products certified, as fair production is most profitable. Effects are then the same as for ethical labelling and high fairness.

Public policy 3, international standards, differs from the other two strategies in that profit-maximizing firms no longer have the option of unfair production, and consumers therefore have only the fair alternative. At the same time, if consumers are aware of the standards, they will know that all South products are fair.

With no fairness, the effects of international standards may be predominantly negative. Though some workers receive the higher fair wage, many others may lose their job. Also, North consumers are worse off since the price of the South good increases. With intermediate fairness, effects depend on whether consumers are aware of the standards. If they are, all South products receive the fair price. This means that fair firms can employ more workers. It also means that the reduction in employment in profit-maximizing firms due to the higher costs of respecting standards is smaller, because they receive a higher price for their products. However, if consumers are not informed, effects are similar to those when there is no fairness. With high fairness and informed consumers, standards are irrelevant since fair production in any case is most profitable. Effects are then the same as for the two policies described above. However, if consumers are not informed, standards again may have predominantly negative effects, even though consumers now would in fact be willing to finance the higher costs of respecting the standards. An important policy implication seems to be that an introduction of international standards needs to be combined with informing consumers.

Finally, I briefly discussed *Public policy 4*, ethical investment, here meaning that the authorities require fair production in the firms they own. Ethical investment might e.g. be a way of ensuring a fair alternative to consumers when there are no fair firms in the South market. The effects are similar to those of international standards. However, public ethical investment cannot cover all South firms.

In my view, the main implications for public policy are as follows. First, the analysis suggests that helping consumers in ethical consumption can have beneficial effects both for consumers in the North who have altruistic preferences, but also for many workers in the South. However, there might also be negative effects if consumers have no fair alternative. Conversely, requiring fair production might have harmful consequences if one cannot exploit consumers' fairness. Therefore, there is a need for *co-ordination* of fair producers and fair consumers. This is exactly what Fairtrade means. The main message in this thesis is that public policy may have a role in coordinating agents. Of the policies discussed, guaranteeing a fair alternative seems to offer most of the positive effects while minimizing possible negative effects. However, a question is whether certifying fair products will lead consumers to believe that other products from the South are not fair. Still, in practice I do not think this effect is very important.

I also emphasize that I defined high consumer fairness as the fairness of consumers necessary to make fair production absolutely more profitable. The *actual* extent of fairness, and therefore additional willingness-to-pay required of course depends on how large is the cost of fair production relative to unfair production. In particular, if these extra costs are not particularly high, consumers do not need to be willing to pay lot more for fair production. To better determine the effects of different policies, we therefore need to estimate both the extra willingness of consumers to pay for fair production, as well as the extra cost of fair production.[134]

I now look at some qualifications to the analysis. First, readers have probably missed a discussion of the possibilities of implementing the various public policies. Throughout I have assumed away such problems, but in practical policy, they must be taken into consideration. As regards labelling, an example is the scepticism of many activists that consumers can drive change by shopping for the right pair of jeans.[135] As they see it, the problems are structural, and require action at the industry level, rather than the firm level. Even if there is a willingness to pay among consumers for fair products, it will be some time before the systems for ethical sourcing and monitoring are in place. Further, some have questioned the ability of schemes like Fairtrade to monitor that standards are in fact being fulfilled. For instance, Tucker (2006) refers to allegations that coffee from a plantation in Peru where workers were paid below the minimum wage, was being sold as Fairtrade coffee. However, to the extent

[134] Simon Pahle has argued that though there will be costs for the developing countries from respecting standards, these are unlikely to be so high as to take away their competitive advantage (*Ny Tid* nr. 47, 1.-7. desember 2006, p.55).
[135] See Engler (2006).

that such problems are due to lack of resources, public support could both hasten the development of systems for ethical sourcing, and strengthen monitoring capabilities of organizations like Fairtrade.

It has also been argued that international standards will not be effective. One reason is the lack in many South countries of functioning bureaucracy and law and order, and problems of corruption. Even existing standards are only therefore implemented only to a limited extent.[136] Further, as the WTO process is based on consensus, it seems unlikely that one can reach agreement on standards that will have any practical significance.[137] In addition, as was also reflected in the analysis, standards will not cover the informal sector, which in many countries employs the majority of workers.[138] Most economists do not see trade policy as an efficient tool for addressing the problem of labour standards. However, I would like to reiterate the result from the analysis that the fulfilment of international standards is maybe not a cost increase like any other cost increase. If consumers are fair, the fulfilment of standards might activate a higher willingness to pay for South products.

Another qualification is the following. In the analysis, I assumed that firms are able to determine whether fair production is most profitable or not. In practice this is unrealistic. Possibly, we have a "hen-and-the-egg"-situation, where consumers do not buy Fairtrade products because they are not available, while the firms do not offer such products because they are unsure of whether consumers will buy them.[139] Public policy could perhaps here help by *co-ordinating* agents.

Finally, just some words on a possible interesting perspective on Fairtrade. Throughout, I have assumed consumers' preferences for Fairtrade to be exogenously given and constant. However, these might themselves be endogenous to various factors, such as institutional arrangements, or social norms.[140]

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[136] Snoen (2004:139).
[137] Snoen (2004:139), Hoekman and Kostecki (2001:448-52).
[138] Snoen (2004:139). However, as Gaarder (2004) notes, many firms in the textile industry lay off workers from their factories, and instead employ them as home-workers. Regulation might in these cases help workers have more stable and secure employment in regular production.
[139] This point was mentioned in the NORAD-seminars on trade with developing countries in 2006.
[140] See Nyborg (2006d) for a discussion of social norms and the possible effects of public policy.

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Appendix A Fairtrade producer standards principles

Standard Principles - The following Fairtrade Standards principles are considered in all Fairtrade Standards applicable to small farmers and workers and their organizations:

Fairtrade Standards distinguish between minimum requirements, which producers must meet to be certified, and progress requirements that encourage producer organisations to continuously improve in all standard's areas and to invest in the development of the organizations and their producers/workers. This concept is developed for the target group of Fairtrade; disadvantaged producers. It encourages sustainable, social, economic and environmental development of producers and their organizations.

1) Social development: For small farmers Fairtrade Standards require an organizational structure that allows the farmers to actually bring a product to the market. All members of the organization need to have access to democratic decision-making processes and as far as possible participate in the activities of the organization. The organization needs to be set up in a transparent way for its members and must not discriminate any particular member or social group.

For hired labour situations the Fairtrade Standards require from the company to bring social rights and security to its workers. Some of the core elements are: training opportunities, non discriminatory employment practises, no child labour, no forced labour, access to collective bargaining processes and freedom of association of the workforce, condition of employment exceeding legal minimum requirements, adequate occupational safety and health conditions and sufficient facilities for the workforce to manage the Fairtrade Premium.

2) Economic development: For all products Fairtrade Standards require the buyers to pay a Fairtrade Minimum Price and/or a Fairtrade Premium to the producers. The Fairtrade Minimum Price allows the producer to cover the costs of sustainable production. The Fairtrade premium is money for the farmers or for the workers on a plantation to invest in improving their livelihood. Premium money in this sense is meant to improve the situation of local communities in health, education, environment, economy etc. The farmers or workers decide themselves on what are the most important priorities for them and manage the use of the Fairtrade Premium.

Also, Fairtrade Standards require buyers to give a financial advance on contracts, called pre-financing, if producers ask for it. This is to help producers to have access to capital and so overcome what can be one of the biggest obstacles to their development. This promotes entrepreneurship and can assist the economic development of entire rural communities.

3) Environmental development: Fairtrade Standards include requirements for environmentally sound agricultural practises. The focus areas are: minimized and safe use of agrochemicals, proper and safe management of waste, maintenance of soil fertility and water resources and no use of genetically modified organisms. However, Fairtrade Standards do not require organic certification as part of its standards. Higher costs for organic production are considered though, by higher Fairtrade Minimum Prices for organically grown products.

Fairtrade Standards principles specific to small farmers' organizations only

- **The Members must be Small Producers**. The majority of the members of the organization must be small producers who don't depend on hired workers all the time, but run their farm mainly by using their own and their family's labour.
- **Democracy**. Profits should be equally distributed among the producers. All members have a voice and vote in the decision-making process of the organization.

Fairtrade Standards principles specific to Hired Labour situations only

- **Management of the Fairtrade Premium**. The so-called Joint Body, which includes workers and management, is, among other functions, responsible for the management of the Fairtrade Premium in accordance with Fairtrade Standards.
- **Forced labour & child labour**. Forced labour and child labour is prohibited.
- **Freedom of association & collective bargaining**. Workers have the right to join an independent union to collectively negotiate their working conditions.
- **Working conditions**. Working conditions are equitable for all workers. Salaries must be equal or higher than the regional average or than the minimum wage in effect. Health and safety measures must be established in order to avoid work-related injuries.

Source: FLO (2006e). See FLO (2005, 2006a) for the detailed Generic Fairtrade standards for small farmers organizations and hired labour situations respectively.

Appendix B Some sources of ethical information

In this appendix, I give some examples of sources of ethical information, taken from Terragni, Jacobsen, Roos, Torjusen and Vittersø (2006:51-3) and Table 5.1 in Berry and McEachern (2005:75) I have focused on sources relevant in connection with the concerns of Fairtrade. In addition, there are many sites e.g. for environmental concerns.

Websites

www.ethiscore.org

www.responsibleshopper.org

Online ethical shopper's guide.

www.ethicalconsumer.org

Homepage of the British ethical consumer organization.

www.etiskforbruk.no

Norwegian portal for ethical consumption.

www.norwatch.no

Norwegian site for monitoring Norwegian businesses' activities in the South.

www.cleanclothes.org

Campaign for improving conditions in the global garment industry.

www.socialinvest.org

Website for social and ethical investment.

www.corporatecritic.org

www.corporatewatch.org.uk

Online information about companies.

http://www.coopamerica.org/socialinvesting/shareholderaction/

For individual investors seeking information on shareholder action.

www.amnesty.org

Amnesty International website.

Books and magazines

The Rough Guide to Ethical Shopping

The Ethical Consumer Magazine (also available online)

Appendix C Fairtrade towns

In this appendix I briefly present the Fairtrade town campaign, which has been important for public "fair" procurement.

Fairtrade towns make commitments on among other things public purchases of Fairtrade products and on spreading information about Fairtrade. The campaign started in England, with Garstang becoming the first Fairtrade town in 2000. There are now 173 Fairtrade towns in Great Britain.[141] In August 2006, Sauda became Norway's first Fairtrade town.[142] Today there is active work in 25 Norwegian communes to have local politicians make binding commitments.[143]

To become a Fairtrade town, or any other populated area, the following 5 goals must be met:[144]

- The local council must pass a resolution supporting Fairtrade, and serve Fairtrade coffee and tea at its meetings and in offices and canteens.
- A range of Fairtrade products must be readily available in the area's shops and served in local cafés and catering establishments (targets are set in relation to population)
- Fairtrade products must be used by a number of local work places (estate agents, hairdressers etc) and community organisations (churches, schools etc).
- Attract media coverage and popular support for the campaign.
- A local Fairtrade steering group must be convened to ensure continued commitment to Fairtrade Town status.

[141] *Ny Tid* nr. 12, 24.-30. mars 2006, pp. 26-7
[142] *Aftenposten*, morgen, 20.08.2006, pp. 14-5.
[143] *Aftenposten*, morgen, 29.12.2006, p.22.
[144] Fairtrade Foundation (2007).

Appendix D Fairtrade products in Norwegian supermarket chains

Source: Fairtrade Max Havelaar Norge (2007b). Note for non-Norwegian readers: ”Alle butikker” (A) means all outlets and ”Noen butikker” (N) means some outlets.

	Coffee	**Juice**	**Bananas**	**Tea**	**Rice**	**Chocolate**	**Roses**	**Sugar**
Meny	A	A	A	A	A	N		A
Centra	A	A	A	A	A	N		A
Ultra	A	A	A	A	A	N		A
Spar	A	A						N
Joker	A							N
Kiwi	A							N
Nærmat	A							N
Rema 1000	A							N
Rimi	A							N
ICA Supermarked	A	N	N	N				N
ICA Maxi	A	A	A	A				N
ICA Nær	A	A	N	N				N
COOP Mega		A	N	N		N		N
COOP Obs		A	N	N		N		N
Eurospar	A	A						N
Bunnpris	A	N						N
Sparmat	A							N
Drageset	A	A	A	A	A			N
Bikuben	A	A	A	A	A			N
Safari	A	A	A	A	A			N
Nærkjøpmenn	A							N
Jacobs	A	A	A	A	A			N
CC Marten	A	A	A	A				N
Helgekjeden	A							N
Price Club	A							N
Butikkringen Østlandet AS	A							N
OK-kjeden	A							N
	A							
Livi	A							
Service Mat	A							
Deli DeLuca	A			N				
Helios	N			A		A		
Helsekostbutikker	N			N		N		
Mester Grønn							A	A

A = Alle butikker

N = Noen butikker