The Myth of Fair Prices:
A Graphical Analysis

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Abstract: The issues of fair trade and in particular fair price policies, have been neglected in most international trade courses. The authors show how the latter can be explained to undergraduate students applying the simple graphical methods normally used in general equilibrium trade theory. They show that fair pricing strategies can be looked upon as a suboptimal device for redistributing the gains from trade as compared with a transfer of funds.

As the number of unilateral and multilateral trade agreements has grown, calls by labor movements and environmental groups for minimum labor and environmental standards have increased. To address the concerns and questions raised by these groups, trade economists have written at length—in the relatively new area of fair trade theory—on the possible effects of standards, both labor and environmental, and on related questions regarding the so-called "race to the bottom" (e.g., Bhagwati and Hudec 1996). On the demand side of this phenomenon, there has been an increased call on the part of consumers in the developed world for products for which a guaranteed fair price has been paid to workers in the developing world.

Products such as ethical fruit juices, fair-price teas and coffees and other foodstuffs, and raw materials have appeared on the market to cater to this increased demand. Freeman (1996, 91), in addressing this new demand, has argued that these ethical products constitute an "extended product" because ". . . The consumer who cares whether the worker makes products in a palace or sewer consumes not only the physical good but the associated work conditions." Despite Freeman's assertion that these extended products provide a valid avenue for raising labor standards, additional questions need to be addressed regarding these extended products. For example, are there other effects of channeling wealth to developing countries through consumer goods prices? That is, despite the particular reason one expounds for using fair prices (to raise labor standards), are they the best way to achieve one's goals? Outside of Freeman, little economic analysis of these questions regarding fair prices or labeling policies has been done,

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especially in the teaching of trade theory. We argue that it may be less efficient to pay fair prices than it is simply to donate funds directly to the targeted countries. The reader may recognize this argument as an application of Harry Johnson's (1965, 5) two propositions. First, the solution to domestic distortions should not be found in protectionism. Second, protection, if introduced to correct domestic distortions, may lead to a suboptimal outcome from an economic welfare perspective, even when compared with the original free trade situation.

We define what a fair price is and then look at the costs stemming from the use of fair prices to the rest of the world and to the country targeted. Finally, we outline the possibility of a more efficient approach to assistance.

FAIR PRICE?

What does it mean to pay a fair price for coffee? One definition could be that a fair price may be said to be equal to the market-determined price of a good plus an additional premium that consumers are willing to pay for the guarantee that specific inputs are paid at a certain socially acceptable rate. Therefore, fair prices allow consumers in the developed world to redistribute a certain proportion of their gains from trade to a country (or factors within the country) from which they have imported a good or service. By extension, this means that goods sold at fair prices must be goods produced in countries by individuals whom consumers in the developed world have targeted as in need of assistance. For example, by targeting coffee from South America for the payment of fair prices in North America, North American consumers are channeling a proportion of their personal share of the gains from trade directly to these coffee growers.[1] To be clear, only some countries that produce coffee are so favored. Therefore we assume that the world price of coffee (which is the price that is paid to nontargeted coffee-growing countries) remains unchanged. This is where the problem arises.

When assistance is targeted to some developing countries through the payment of fair prices, relative prices in these countries are changed; this leads to a change in incentives. Using coffee as an example, we show in Figure 1 what results when consumers decide to use their purchases of coffee to channel assistance to certain growers in the developing world.[2]

The payment of fair prices for coffee raises the price of coffee relative to that of other goods produced in the developing country. This leads to a shift in productive resources in the targeted developing country away from the production of other goods toward the production of coffee. The higher price received for coffee in the targeted developing country improves its terms of trade and leads to an increase in its aggregate income at world prices (a movement from Y_0 to Y_1). The developing country will now maximize its consumption at B'—the point at which the indifference curve Y_1 is tangent to BB'. At B', the value, in terms of other output, of this new consumption bundle at world prices is 0T. Because consumption increases from A' to B', the developing country as a whole benefits unambiguously from being the target of fair pricing. However, the cost of fair pricing to the rest of the world is more complicated and can be divided into three components.

FIGURE 1. Fair prices and the developing world.

COSTS TO THE REST OF THE WORLD FROM FAIR PRICING

The first cost component to the rest of the world from fair pricing stems directly from the difference between the fair price of coffee and the market-determined price of coffee.[3] The decision on the part of consumers in the developed world to pay a premium above the market-determined price of coffee results in a donation channeled through the price of the targeted good (a sort of donation per unit) to the growers in the developing country. Measured at world prices, revenue attained through a fair-price policy would be collected theoretically at B'. Thus this transfer of fair-price revenue shown by UT in Figure 1 is the first cost component of fair prices.

The second cost component results from the change in the price of the targeted good itself. The voluntary action of the consumer in the developed world results in an increase in the export price received by the targeted growers, leading to a shift in productive resources toward the production of coffee (in Figure 1, the shift from A to B).[4] This shift in production priorities on the part of targeted growers in the developing country allows for a maximization of domestic consumption. The value, in terms of world prices, of the new aggregate production

point *B* reflects world resource costs. The value of *B* is lower than the original production point *A*; production in terms of other output has decreased from 0U to 0V. Thus, the second cost component to the rest of the world of fair pricing arises from the increase in the production of coffee sold at fair prices. This is shown in Figure 1 by VU. The total direct cost of the fair price for the developed country, in terms of other output, is VT.

A third indirect but often ignored effect of fair pricing flows from the observation that the overall world consumption of coffee —like other foodstuffs and natural resources—is inelastic. In the fair price model described above, the production of coffee at fair prices increases, which leads to a reduction in coffee produced by nontargeted countries. Targeted growers are made better off, but nontargeted growers must reduce their output.

INTERNAL EFFECTS

Fairly priced coffee means higher coffee prices in targeted countries and higher income for their coffee growers; growers are made unambiguously better off. If we were to stop there, industries other than coffee and industries in other nontargeted countries would be neglected. In the context of a specific factor model in which land is specific to coffee production, as the return to the targeted grower's land increases, the return to any factor specific to an activity that is not targeted such as fruit farmers, coffee growers in a nontargeted country, factory workers would fall by a magnified amount. This would happen because the nontargeted specific factors must still compete with the targeted coffee growers for shared factors such as water and electricity (Ruffin and Jones 1977).

Finally, because fair prices distort information about a country's long-term comparative advantage, fair pricing may lead a developing economy down a dangerous path of dependence on the premiums from fair prices. This internal distortion as well as the internal distortions in nontargeted countries[5] may yet induce the highest costs from fair pricing.

A MORE EFFICIENT APPROACH TO ASSISTANCE

What would happen if consumers did not channel their assistance through commodity prices but rather through direct transfers to the country? First, the size of the transfer needed to bring about the same increase in aggregate income in the developing country would be smaller UT versus VT (Figure 1).

Second, the transfer, unlike the payment of fair prices, does not target certain groups within the developing country. It spreads the donation throughout the economy, leaving price incentives unchanged. One can argue that we are ignoring the revenue raising cost in the donor country and the distribution cost in the targeted country. However, as in the case of costs associated with monitoring and enforcing whether fair prices are truly fair—whether the workers receive what is intended—the costs associated with revenue raising and distribution in the case of a donation may not be trivial. Which of the two policies—donation versus fair pricing—has the lowest cost in this regard is an empirical question rather than a

theoretical one. Thus, the empirical question aside, the use of a transfer rather than a fair price to channel assistance to a developing country removes the price distortion, which removes the incentive to (inappropriately, from a world resource cost perspective) reallocate resources.

Third, the use of a transfer is more beneficial to the developing country. Unlike the situation under the regime of fair pricing, the developing country is not required to maximize its consumption relative to distorted domestic prices, but instead, maximizes its consumption relative to world prices. This allows it to obtain a higher level of aggregate income (shown by point C on indifference curve Y_2 in Figure 1).

Finally, by not distorting coffee prices, the nontargeted growers will not be forced to alter their production decisions, and the third cost component of fair pricing disappears.

CONCLUSION

Fair pricing, despite making a targeted country unambiguously better off, has serious costs when the country's internal production incentives are taken into account. Both import competing and other exporting sectors could be made worse off. Once fair pricing policies are put into effect, there is an opportunity over time for these targeted countries to become dangerously dependent on these policies. Ultimately, if the developed world would like to help developing countries, the most effective way to do so may be by direct transfer. Although the impetus for fair pricing may be noble and intuitively appealing, fair pricing is inefficient for both the receiver and the donor and must be considered an inefficient device for the redistribution of wealth. The fair price policy attempts to raise incomes by distorting prices, whereas a simple transfer more efficiently reaches the same objective.

The issue of fair pricing can be used as a powerful teaching tool in international trade courses. Fair pricing provides a good example for outlining the workings of the price system and price incentives, the merits of the specific factor model in analyzing policy, the graphical approach to trade theory, and, if one wishes, the question of enforcement costs of standards or the revenue raising and distribution costs of the donation.

NOTES

1. We assume throughout the article that the targeted workers get what is intended for them. However, the cost of ensuring and enforcing that ethical products are in fact ethical should by no means be considered trivial and should be factored into any discussion of fair prices.
2. In Figure 1, we assume homothetic preferences. This assumption simplifies the discussion, but in no way does it alter the conclusions.
3. Recall, for simplicity, that we assume that the producer who is being helped is sufficiently small that world coffee prices do not change in consequence.
4. We have said nothing about the level of exports. For example, it may well be that if the income effect is very strong, the developing country may actually export less. This intriguing possibility does not affect our results.
5. With a specific factor model, one could imagine the converse situation occurring in nontargeted countries. The nontargeted coffee grower sees his or her return drop by a magnified amount as other industries, which see their relative returns increase, are able to obtain a larger share of the common factors.

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