

With the rapid growth of the fair trade movement, how do rational consumers allow ethics to influence their decisions when maximising utility, through the consumption of fair trade coffee?

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This essay aims to examine the principles behind the fair trade movement, one which has boomed in developing nations, and therefore the ways in which it is marketed and affects consumer behaviour. Consumers wish to maximise their utility through the bundling of variable amounts of goods available to purchase within their budget. Through analysis of the economic principles of resource allocation and the use of graphical illustration I aim to explore the notion of utility and determine why the voluntary act of participating towards fair trade revenues has become hugely popular among wealthy nations.

The coffee industry is a unique one. The commodity itself is the second highest traded in the world, after oil. The production process, however, isn't like ones for commodities of similar importance to the market. Coffee farming is predominantly carried out by small family run businesses – 70% of the coffee produced globally (Bacon, 2008. p50). Because the plants on which it grows thrive around the equator, most farmers live in developing countries where the price volatility of coffee puts them at risk of severe financial strain in times of shortages or if the market pushes prices below a reasonable level which allows them to cover their costs and continue production.

The fundamental idea behind fair trade is that, in the developed world, we are in a position to reduce exploitation of producers in poorer countries. This is achieved by “offering better trading conditions to, and securing the rights of, marginalized producers and workers – especially in the South.” (FINE 2001) Those companies who choose to join the fair trade industry must have their products certified by the Fairtrade Labelling Organisations (FLO) and are therefore supporting the notion that producers of goods subject to price volatility should be protected through payment of a minimum price to cover living and production costs, a price which adjusts whenever the market shifts above the minimum threshold.” (The Economist 2014). This movement therefore takes a different approach to the traditional idea of business being first and foremost for profit, instead attempting to ‘change the relationship between producers and consumers’.

A product which was once only found in churches and charity shops, the concept of fair trade coffee emerged with little impact or awareness, providing a small group of consumers with a new form of utility – ethical justice. In its early life, the consumption of fair trade coffee came with a significant sacrifice. Lacking in the taste and quality of mass-marketed coffee, fair trade coffee became a substitute for consumers who prioritised their ethics, and considered this sacrifice acceptable in order to contribute towards a greater level of welfare in developing nations. Working under the assumption that rational consumers wish to maximise their utility within a given budget constraint, it can be reasoned that they must derive an equivalent level of utility from the inclusion of this new component, rather than just from the satisfaction resulting from consuming the coffee itself.

Although it is argued that in recent years the taste of fair trade coffee is no longer sub-standard it can still be assumed that when shopping for coffee, each consumer will have their own opinion of which level of taste is acceptable within their budget constraint for a given level of ethical justice towards which they feel they have contributed. Reinstein and Song (2008) point out that if a consumer is altruistic, informed and rational then they will understand, through the availability of information on the fair trade movement, that their expenditure on such goods provides some form of increase in the welfare of others, and their utility function ‘depends (in part) on the impact of her actions on others’. This last point is important as it illustrates the fact that for each consumer who meets the criteria for “AIR” (altruistic, informed, rational) their utility function will comprise of two components:

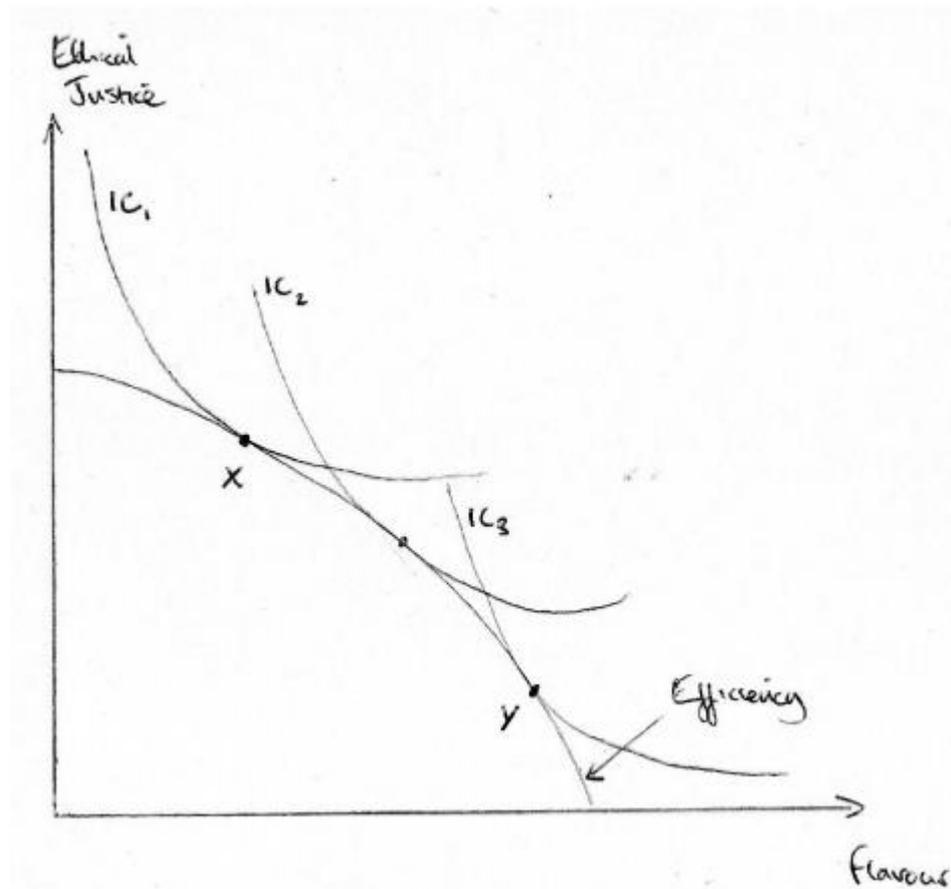
- 1) The satisfaction obtained directly from consumption of coffee
- 2) The satisfaction from contributing to the welfare of others beyond one’s own self-interest.

Since the respective weight of each of these components on their utility function will vary from consumer to consumer, a whole set of indifference curves can be obtained, to demonstrate the varying levels of these two components in each consumer’s most preferred, affordable consumption bundle. Fundamental to microeconomics is the principle that in a decision-making process consumers face trade-offs. (Mankiw & Taylor, 2010) The trade-off in this case for an extremely morally driven consumer would be a sacrifice in taste and quality of coffee for a sense of ethical justice. On top of this, the premium this consumer chooses to pay for an FLO certified product means that for their given level of income they can afford less fair trade coffee to non-fair trade coffee of comparable quality.

In the following diagram a line of efficiency is shown between both extremes of the spectrum, coffee that is 100% ethically sourced by companies which put the welfare of coffee farmers highest in their priorities, marketing themselves this way to consumers, and companies which consider (and market) the quality and flavour of their coffee as its main selling point, with ethics therefore playing a negligible role. If consumers 1 and 2 have indifference curves IC1 and IC2, respectively, then they maximise their utility at points X and

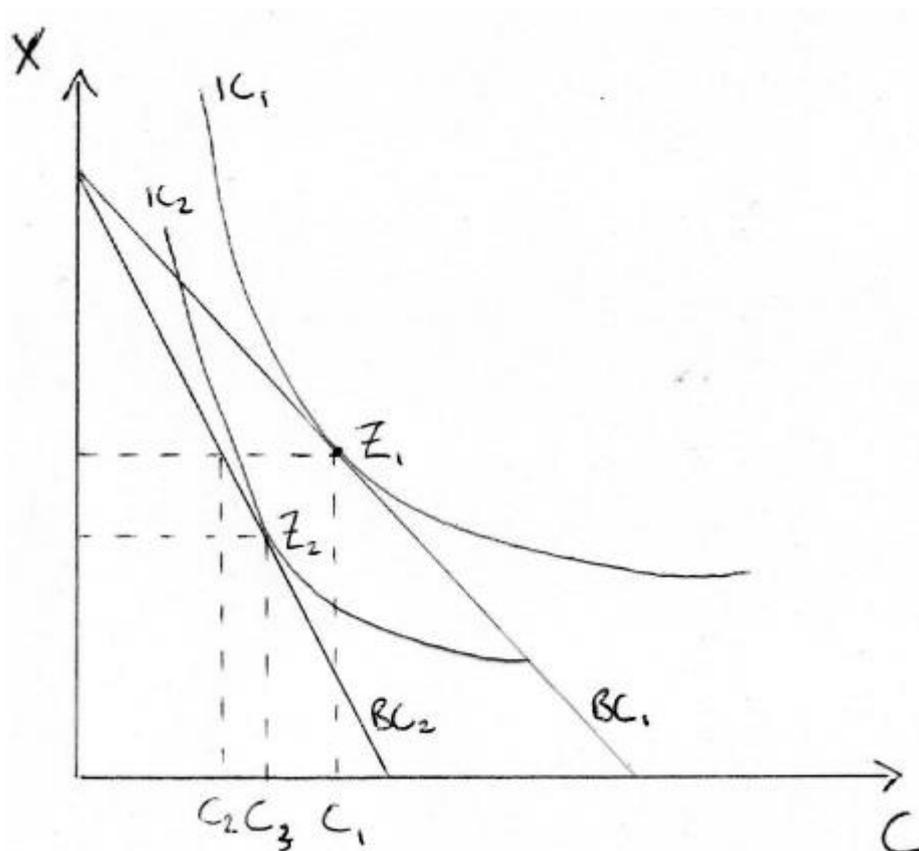
Y respectively, the only points at which their indifference curves meet the curve which represents all efficient combinations of fairly traded and non-fairly traded coffees available. Consumer 1's bundle therefore leans much more towards an ethical perspective and his/her utility functions would involve a heavier weight of the moral component mentioned above, than Consumer 2, whose priorities are more focused towards the taste and quality of their coffee.

Diagram 1



For the purposes of illustrating utility as being more than just the satisfaction obtained directly from consumption of coffee, Diagram 2 (Messier, J. D. 2010 p508) shows a single consumer who initially only buys non-fair trade coffee. The diagram shows this particular consumer's budget constraint in respect to coffee (C) and all other goods (X). At an initial utility maximising point Z1, where the consumer's utility curve is at a tangent to the budget constraint BC1, this individual is able to consume a certain amount of coffee, C1. A key component of the fair trade movement is the premium added to the price of coffee. Consumers who switch to fair trade are therefore choosing to accept this extra cost in purchasing coffee and the resultant decrease in the quantity available to them, since the amount of their budget which was previously apportioned to the purchase of coffee is no longer sufficient to purchase this same amount.

Diagram 2



Because it is only the price of coffee which has effectively changed, in Diagram 2 the initial budget constraint (BC1) rotates in on the y-axis, so that for each previous quantity of all other goods in their potential consumption bundles, a lower level of coffee is available than before. In this consumer's case the quantity of coffee which they have lost from their most preferred affordable consumption bundle, if they hold their consumption of all other goods constant is the difference between C_1 and C_2 . Since point Z_1 is no longer possible, the consumer has to move to another indifference curve, IC_2 , resulting in a new most preferred consumption bundle Z_2 . Following the rules of indifference curves for a rational consumer, that they must be convex, downward sloping and never touching (Mankiw & Taylor, 2010. P431) it should follow that this consumer now experiences a lower level of total utility from the switch to fair trade.

This switch may therefore seem illogical, but the fact that it was completely voluntary and the consumer is able to switch back at any time if he/she so chooses, provides some support to the notion of utility being more than just something derived from consumption alone. Since economics supports the theory that rational people make choices for a reason, this particular consumer must have felt that their decision to switch to fair trade would result in a greater net gain than if they hadn't. This net gain of course takes into account the impact on the welfare of others less fortunate (farmers in developing countries) and is an example of the 'bounded self-interest' discussed by Parkin (2010) which causes individuals to act in a

way that does not necessarily reflect the interest in maximising utility, because of external factors. The external factors in this example are the victims of a Hurricane for whom Lisa decides to trade off a portion of her budget, and in turn allowing her to afford less consumption of goods for herself.

With the availability of comprehensive information regarding fair trade policy and entry criteria for companies, as well as increased publicity, the movement has seen a radical growth from something found only in churches to something widely available across developed nations. In fact the North American and Japanese markets in particular are still growing 'rapidly' (Weber, J. 2007. p109). Since rational consumers wish to maximise their utility within their own financial constraints, it seems the decision to pay a premium for fair trade coffee is a rational one, which must provide some form of utility, coming perhaps from the knowledge that at the margin for each extra cup of coffee you drink that is fair trade you are contributing to the welfare of those less fortunate. Consumers must consider the premium they pay to result in a net gain which outweighs the corresponding loss of purchasing power, so from this perspective the decision to buy fair trade can be seen as the rational and even the most efficient choice for many.

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