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Institutional path dependence: The price of Fairtrade?

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Abstract

Fairtrade has become a familiar trademark for most consumers in the developed world and represents an option for the buyer to purchase a product that has been certified to follow the ethical standards of "fair" trade. This branding has received much critique over the last years concerning Fairtrade's ability to improve the lives of small producers in the developing world. This thesis derives from the theories developed within New Institutional Economics (NIE), which emphasizes the understanding of institutions development as a key factor for analyzing long-term economic growth. By constructing an analytical framework of institutional change this thesis theoretically analyses the impact of Fairtrade's policies on local credit markets. It concludes that the impact of Fairtrade is highly dependent on the initial conditions and could both increase and lower the incentives of changing the institutional framework.

Key words: TCE, Fairtrade, Credit, Institutions, Path dependence

Words: 9953

Abbreviations and Acronyms

FLO Fairtrade Labeling Organization

FINE Fairtrade Labeling Organization, World Fair Trade Organisation (formerly known as International Fair Trade Association), Network of European Worldshops and European Fair Trade Association.

ILO International Labor Organization

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1 Introduction

The option for consumers in the developed world to choose ethically branded products certified by organizations such as Fairtrade, UTZ or the Rainforest Alliance has increased rapidly over the last decade. The principle behind these certifications is that consumers are given a choice to support products that has been produced according to a set of ethical standards developed by the certifying organization. What these standards are and how they are applied varies between the labeling organizations but they all share a common task: to enable the buyer to make an active choice to consume a product that has been produced in line with certain moral values. The message to the consumer is that through the purchase of the branded goods they are contributing to the development of a better world through a “good” form of trade.

Critique against this form of ethical branding has been presented, not only by a broad set of free-trade advocates who argue that the ethical branding implicates that all other trade is unethical and morally unjust, but also from academics whom has studied the consequences of the standards applied by the labeling organizations. The organization that has received perhaps the most attention is Fairtrade, not only because it is the largest and most commonly known certifier, but also because of the minimum price offered to the producer. The results indicate that the very purpose of Fairtrade; to improve the situation for farmers in the developing world, may be counterproductive. Parallel to this debate, economic theory advocates that institutions is the most important factor for explaining differences in economic performance and development between countries, making it a key issue in development research. The connection between Fairtrade and the development of important institutions is thereby an important factor in the evaluation of the effectiveness of Fairtrade as a means to improve conditions in the developing world. A factor that has been given little attention in previous studies.

The relation between institutions and economic development is very complex and can be analyzed at more or less abstract levels. A key factor for the increase of productivity that constitutes economic growth is however access to capital through a well-functioning credit market. The absence of such markets is one of the most important explanations for the economic performance of many developing countries. This has also been identified by Fairtrade and is one of the main motives behind the policies' of providing a minimum price and extended access to credit. The goal of this thesis is thus to analyze the impact of Fairtrade on local credit markets.

1.1 Statement of purpose

The purpose of the study is best described by building on a metaphor by Nobel Laureate Friedrich Hayek in which he compares the evolution of an institution with that of a footpath (Hayek 1952:40-41). A footpath comes into existence by individuals following the tracks of their predecessors. In the beginning each individual will try to find the path that is best suited for his or hers needs, but when the first path has been established, it is likely to ease the trek of future hikers and thereby preferred over finding a brand new path. Over time, as the path evolves through the travels of other individuals, other potential ways are excluded to the benefit of the beaten track. Put differently, the relative price for an individual of creating a new path increases. But a fundamental question remains: is the beaten track really the most efficient way of getting from point A to B? Based on this metaphor, the effect of Fairtrade on domestic credit institutions could be compared to the building of a fully subsidized highway parallel to the footpath, leaving the fundamental question: is it a more efficient way from point A to B?

The main purpose of the study is therefore, through theoretical analysis, to answer the following question:

- **What are the effects of Fairtrade's policies concerning small farmers on local credit markets in the production country?**

In order to answer this question, an analytical framework is constructed using the institutional theories of Oliver E. Williamson and Douglass C. North, applied to the policies of Fairtrade and characteristic problems found in development countries.

1.1.1 Comment on the material

Even though there has been extensive research on the effects of Fairtrade at the local level, a substantial part of these studies can be challenged due to their close connection to either the Fairtrade community itself or to ideologically driven free-trade advocates. Since the independence of these studies can be questioned, the background work of this study has focused on finding research with the minimum requirement of no formal ties to any of the two camps. However, due to its considerable share of the total research conducted and sometimes high relevance to this thesis, some of these studies are included in lack of alternative sources.

1.1.2 Disposition

Starting with an introduction to institutions as perceived in this thesis (chapter 2), the relevant background setting is constructed by presenting the features and critique of Fairtrade followed by a description of the characteristic problems of credit markets in developing countries (chapter 3). Chapter 4 presents the analytical frameworks which are applied in Chapter 5 for an analysis of the impact of Fairtrade using the described background setting. Chapter 6 summarizes the results and presents a conclusion.

2 Institutions

This section aims to provide a conceptualization of how institutions are defined in this thesis. North's well-known definition of institutions as humanly devised constraints which structure interactions is the solid base of the definition, but is clarified through a more detailed description of institutions as hosts of transactions. Furthermore it provides a link between the issues related to institutional performance and economic progress.

2.1 The key ingredients

"Institutions are the humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)." (North 1991:97)

The above definition of institutions has become well known and broadly used in the field of institutional economics, and will serve as a base for the conceptualization of institutions used in this thesis. Perhaps the most important aspect of the definition is that institutions are not taken for granted but considered and defined as a humanly devised means to structure various relations, indicating that they change over time. The definition has however a negative connotation by the description of institutions as primarily "constraints" and does not depict the dualistic nature of institutions that also *enable* different forms of interaction. From the enabling perspective, institutions facilitate transactions e.g. communication through language or the transaction of money through a bank, and the constraints imposed is therefore a means to an end. (Groenewegen et al, 2010:30)

The need for institutions to facilitate transactions can be derived from the view that interacting actors are characterized by *bounded rationality*, which means that

they are intendedly rational but restricted due to their limited ability to retrieve and process information (Furubotn & Richter 1997:39). The imperfect information poses a risk to actors involved in a transaction and are therefore in need of further information and securities in order to participate. The role of institutions is to structure this information in order to generate predictability for the actors involved and reduce the obstacles for the transaction to take place. These obstacles are attached to a cost, *transaction costs*¹, and the efficiency of an institution may therefore be evaluated on how much it reduces these transaction costs. (North 1990:8).

To fully understand the concept of transaction costs, it is necessary to further describe the character of these costs. This is best done by using the establishment of a contract in a market transaction as a cognitive tool, ignoring its level of formality. These costs consist of several aspects but may be summarized in the following three main categories (Groenewegen et al, 2010:22):

- *Search and information costs.* These are the costs associated with the initiation of a contract negotiation and can be described as to answer questions such as: Who offers the product/service? What is the quality of the product/service? Is the seller also the full owner of the product?
- *Costs to draft, to negotiate and to conclude the contract.* Time is a major factor but also other costs such as judicial advice, the service of an intermediary or general paperwork.
- *Monitoring costs and enforcement costs.* These could be summarized as commitment costs and to reduce the risk of opportunistic behavior of the contracting counterpart. An example could be verifying the validity of a credit card or the hiring of an attorney to resolve a contract conflict.

¹ In economics the transaction cost can simply be described as the price of an exchange. Imagine a situation in which you would like to buy an apple but in order to do so you need to pay someone to buy it for you. The payment to the person who buys the apple for you is in this case the transaction cost. It's the price of making a deal. Transaction costs are however not an exclusive feature of the market and can be applied to other parts of society e.g. *political* transaction costs, such as the costs associated with participating in a decision-making process. (Furubotn & Richter, 1997:47)

However the above categories of costs could easily be applied to other forms of transactions, such as a political transaction through a democratic election where the voter may need to acquire information about the candidates, spend time voting and to monitor the behavior of the elected politicians through media.

2.1.1 A web of institutions

As described above, institutions facilitate transactions and consist of a set of constraints in order to do so. Institutions can in turn be divided into formal and informal institutions depending on the nature and construction of the associated constraints. *Formal institutions* are defined as *public* rules of behavior, which are characterized by their construction and sanction through a public authority, e.g. laws or a judiciary. *Informal institutions* are in turn defined as *private* rules of behavior, and constructed and sanctioned among private actors. (Groenewegen et al, 2010:25)

Since private actors are both subject to as well as the influence of public rules, there is a clear interdependence between formal and informal institutions. This interdependence generates a web of institutions, and in order to structure their relationships, a hierarchical scheme may be used. Williamson (1998:26) structures institutions in four different levels according to how quickly they change:

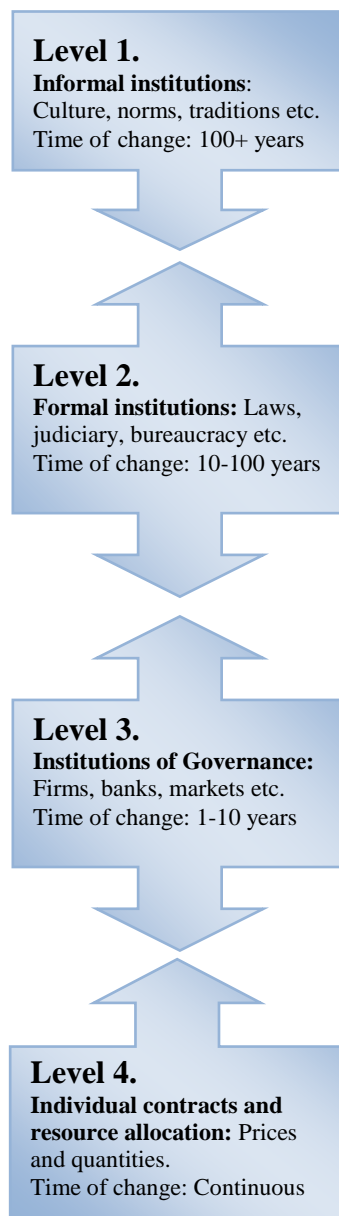


Figure 3.1 Hierarchy of institutions

As can be seen by the schematic presentation above, each level is connected to the previous through a system of feedbacks. Williamson acknowledge however that in the fullness of time, the system is in fact fully interconnected, but it is a useful cognitive tool to bring order in the institutional web (Ibid).

It can also be seen that the institutions are further separated into “Institutions of Governance” and “Individual contracts”, which in this thesis will be considered as “play of the game” while Level 1 and 2 will be considered “the rules of the

game”². This separation is to indicate the primary timeframe of analysis in this thesis and to describe the constraints of the institutional environment in which the actors of the credit market operate.

2.2 Institutions and Economic Development

”The neoclassical result of efficient markets only obtains when it is costless to transact. Only under the conditions of costless bargaining will the actors reach the solution that maximizes aggregate income regardless of the institutional arrangements. When it is costly to transact, then institutions matter. And it is costly to transact.” (North 1994:360)

An economic system built on specialization requires transactions, and these are not for free. Time, information and securities are all factors included in a contracting process of the transaction, and they all have a price. As concluded previously, an institution facilitates transactions and is therefore an important part of the economy’s performance. If the objective is e.g. economic growth, institutions may enable those transactions that are vital to increase the productivity. It could be formal institutions such as well-defined and sanctioned property rights or institutions of governance, such as a bank specialized with the task to transact capital to profitable investments. A well-functioning institution not only enables a transaction, it also do it to a relatively low cost of resources (transaction cost), resources that could otherwise be used in the production. The link between institutions and economic performance has been the subject of much research over the years and empirical studies has found that the quality of institutions is an important determinant for economic performance (e.g. Rodrik et al, 2004; Hall & Jones 1999).

But this insight to the importance of institutions is not enough to explain the differences in economic performance that can be seen across the world. One could say that the question changes from “why are some countries rich?” to “why have

² Williamson specifies Level 2 as “the rules of the game” and Level 3 as “the play of the game”, but the division is consistent with the objective in this thesis to describe a framework that the private actors need to relate to.

some countries developed the right institutions and some not?”. The answer can be found in the concept of *path dependence*, which describes the development of institutions as constrained by the past. Put differently, the fact that history matters. The constraints imposed by history in terms of previous institutions or technological change effects the possible institutional outcomes today. In some cases, the constraints from the past may create lock in effects where the switch to a more efficient solution is very costly, explaining why the very knowledge of which institutions that are effective is not enough. (Groenewegen et al 2010:146).

Returning to the metaphor by Hayek used in the introduction; path dependence is due to the high relative price of finding a new path once the beaten track is established.

3 Background

This section starts with a presentation of the origin and features of Fairtrade and the existing critique. It is followed by a presentation of the characteristics of credit markets in developing countries as used in this thesis. The chapter is concluded by connecting the dots in order to emphasize the relevance of this thesis as a contribution to existing research.

3.1 Fairtrade and Fair Trade

There is a common (yet understandable) misconception of “Fairtrade” and “Fair Trade” as being interchangeable expressions. Even though related, separating the two are important in order to get a better understanding of the debate on ethical trade and the analysis in this thesis.

Fair Trade is best described as a concept that identifies a number of criteria in order for trade to be called “fair” and originates from a broader movement dating back to the 1940’s that emphasized non-exploitative trade as a means to support poor countries. The major actors in this movement are today organized in a loose network named FINE and has agreed on both a general definition³ and criteria’s for what constitutes Fair Trade (Johansson 2009:19-20):

- **Good working conditions, long-term perspective, reasonable salary/payment and environmental awareness.**

- **Open and democratic organizational structure**

³ “*Fair Trade is a trading partnership, based on dialogue, transparency and respect, that seeks greater equity in international trade. It contributes to sustainable development by offering better trading conditions to, and securing the rights of, marginalized producers and workers – especially in the South.*”(FINE 2001)

- **A progressive and attentive dialogue between all stakeholders, where participation is essential**

- **Long term and stable trade**

- **Production shall be performed according to the UN Declaration of Human Rights, UN Convention on the Rights of the Child and ILO core conventions.**

- **Promote equality between men and women**
- **Spread information, educate and implement campaigns**

- **Give priority to products processed in the country of origin**

These criteria are in turn used by the organizations in order to certify and label different products as meeting the requirements of “Fair Trade”. The most common label is *Fairtrade* which follows a set of guidelines developed by one of FINE’s members, FLO. These guidelines are in turn used by the certifying body FLO-CERT which has constructed a framework of components that constitutes the criteria for a product to be certified as “Fairtrade”. The certification mainly covers small farmers, but it is also used to certify companies using hired labor.

The components of the Fairtrade certification can be summarized as follow (Johansson 2009:24):

- **Organizational requirements** – An important part of the fair trade initiative is that small farmers are organized in democratic forms. This is predominantly done through cooperatives (FLO-CERT 2012a). Furthermore, only producer organizations can be certified, not individual producers. In the case of hired labor, the requirement is to allow unionizing. (FLO-CERT, 2012b)

- **Standards** – The standards aim to ensure a minimum level of social and environmental responsibility in the production and trade of certified

products. Furthermore, if needed, producers shall receive payment in advance. (FLO 2012a)

- **Minimum price and premiums** – One of the Fair Trade movement's most important critiques of conventional trade is that producers are sometimes forced to sell their products below the production costs. In order to ensure that these costs are covered and compatible with the social and environmental standards, the producer is offered a minimum price. In addition to this, a premium is provided to the cooperative which is to be reinvested in the business or projects such as a school, infrastructure or low-interest loans. (Ibid)

There is however an associated cost for farmer's joining Fairtrade. First of all, farmers may need to adjust to the production requirements (environmental and social). Secondly, there is a direct cost⁴ of joining Fairtrade through the certification fee paid by the producer organization. The individual farmer's cost of getting access to Fairtrade is thus dependent on the number of members in the organization (FLO-CERT 2011).

The sales of Fairtrade certified products have continuously increased over the last decade and sales grew with 27% between 2009 and 2010 (FLO 2010). But even though Fairtrade has had a rapid growth in sales, its share of the market is still small. For example the Fairtrade product with the largest market share in Sweden, bananas, only constituted 6, 9% of total sales. There are exceptions, e.g. were 55% of all bananas sold in Switzerland 2006 certified by Fairtrade, and the corresponding figure for Great Britain was 25% (Krie 2008).

However, as Johansson (2009) shows, Fairtrade certified products only constitutes a fraction of the total export of these goods. Hence, Fairtrade's impact on the great number of farmers in the developing world is still very small.

⁴ These costs can broadly be separated as the application fee, the annual membership fee and new products certification fee. Fees 2011: Application=€25/nr of members, Annual fee=€610/ nr of members (50-100 members), New product=€180/ nr of members. (FLO-CERT 2011)

3.1.1 The impact of Fairtrade

Several studies show a positive effect of Fairtrade for its members: the offered minimum price has provided stability, the social premium has provided schools (Valkila & Nygren 2010) and the ability to negotiate prices through the producer organization has had a moderating effect on the buyers' market power (Ronchi 2006). Fairtrade has to a great extent done what they set out to do.

But the effects of Fairtrade are not without critique. The most common argument is that, even though Fairtrade fulfill many of their goals, it still does not solve the underlying problem. And perhaps more problematic, by ignoring the relation to the underlying problems it may create new ones. Much of this critique has been aimed at the minimum price.

Its critics argue that it increases the supply of a good that is already at a low world market price due to high levels of production. By increasing the profitability of producing a good by offering a price over market value, a structural change of production to more profitable goods is not undertaken since the signaling system of demand is blocked (Johansson 2009:42). The least efficient producers may thus stay even though they would be more productive in other sectors. For example, in a study from Costa Rica, Fairtrade coffee cooperatives are predominantly found in areas that is least suitable for coffee production (Ibid:37). These are the producers with the least ability of competing in the world market long-term, yet Fairtrade has assured that coffee production is still profitable. Hence, the minimum price stimulates an oversupply and affects the farmer's choice of production.

In line with this argument is the fact that the benefits of Fairtrade are connected to the farming of a specific crop. This means that farmers choice of production is not only effected by the minimum price, but also by the associated benefits of Fairtrade, e.g. stability through payment in advance, the social premium and low-interest loans through the cooperative. (Ibid: 54)

3.2 Credit in the development context – problems and features

In order for a theoretical analysis to be relevant, the context to which it is applied is of outermost importance. The Fairtrade system is based on the identification of common characteristics in developing economies and is applying a universal strategy in order to solve the identified problems. There are of course reasons to criticize these forms of generalizations, which ignores local differences, not least from the institutional perspective that this thesis derives from. However, due to a lack of comprehensive empirics in a single case and the fact that the subject of analysis is a general strategy, this thesis is focusing on the generalizing value of retaining a high level of abstraction. This section is therefore aimed at providing the relevant background setting, and like Fairtrade's analysis, it is based on common characteristics among developing countries.

In general, low-income countries share an institutional environment that is characterized by low levels of education, weak judicial systems, corruption, limited access to capital and an unstable political environment. These are all important components for an economy's performance, not least in relation to the price and access of capital, which is key for the increase of productivity that constitutes economic growth.

The basic principal of any market, including the financial, is the presence of a supply side and a demand side. In a competitive financial market, some individuals are willing to postpone their consumption in exchange for a return (supply side) while others are willing to borrow in order to consume or invest (demand side). When all mutual gains from trade has been realized (there are no potential *Pareto improvements*), the market reaches an equilibrium that is said to be an *Pareto efficient allocation*, meaning that there is no one who will be better off without making someone else worse-off. (Besley 1994:30)

However, a prerequisite for a lender's willingness to engage in the capital market is information about the borrower's ability and intention to pay the debt. Assuming that lenders want to maximize their profits, this information is crucial

in order to determine the probability of repayment. Furthermore, the lender must be able to monitor and sanction deviations from the contract. In contrast to the idealized market described above, information, monitoring and enforcements is not costless and perfect in the real world. Keeping the requirement of realized Pareto improvements and incorporating information and enforcement imperfections, the market equilibrium should instead be defined as exhibiting *constrained Pareto efficiency*. This means that a lower level of lending may be an efficient allocation given the present transaction costs, and Pareto improvements are only available if these are reduced (Ibid). This reasoning is compatible with all markets, but its implications become perhaps even clearer when analyzing the efficiency of rural credit markets in developing countries.

The concepts of moral hazard and adverse selection are a good starting point in order to explain the efficiency loss of high transaction costs. *Adverse selection* in the credit market is basically the lenders inability to determine the characteristics of a borrower *ex ante* the signing of a contract, e.g. his or hers preferences for undertaking a risky project. Lending is always accompanied by the risk of not getting repayment and in order to cover the losses, the lender charges a risk premium. Conversely, the borrower's return decreases with a higher interest rate. If lenders are not able to discriminate between borrowers on the riskiness of their project, they will set a single interest rate. Because of defaults in the more risky projects, the interest rate needs to compensate this through a higher risk premium. This means that projects with a lower risk may no longer be profitable, and consequently those borrowers will no longer demand credit. Since the lender would make a profit if it was possible to adjust the interest according to risk, a Pareto improvement is possible if information is increased.(Ibid:35)

Moral hazard in the credit market is best described as an information asymmetry between the lender and borrower, where the borrower has private information about his or hers effort to repay the loan. In contrast to adverse selection, moral hazard poses an *ex post* problem to the lender. The borrower may take unexpected risks, not put enough effort into realizing the project or in other ways reduce the probability of repayment. The lender must therefore be able to monitor how the money is used and be able to sanction deviations from the contract. If the lender is not able to impose the cost of these measures on the specific borrower, the result is an increase in the overall interest rate through a

higher risk premium on all lending. As in the case of adverse selection, a Pareto improvement is possible if the lender is able to effectively monitor the implementation of the contract and in the case of deviation impose the costs on the specific borrower. (Ibid:37)

The problems of adverse selection and moral hazard are not unique for the development context, but in contrast to other settings there are limited abilities for the lender to lower the associated transaction costs. This limited ability is mainly due to a weak institutional environment not able to lower the associated risks. The perfect example is the use of collateral in loan contracts, which can be used to screen and sanction opportunistic behavior. If the borrower is required to put up collateral in exchange for a loan, those borrowers with the more risky projects will be less inclined to do so since they are the most likely to lose the collateral, and consequently reduces the effect of adverse selection. If they still wish to engage in the deal but deviates from the contract, the lender is able to impose the cost on that specific borrower by collecting the collateral, thereby reducing the effects of moral hazard. However, even though attractive in theory, the use of collateral is highly dependent on the institutional environment the credit market is part off, as can be seen using property as an example. (Ibid:33)

The use of property as a collateral is foremost dependent on clear property rights. The lender must be confident that the borrower actually has the rights to the property in order to accept it as collateral. Furthermore, the judicial system must ensure that the contractual agreement is honored so that the lender is able to assume ownership in the case of default.(Besley 1995:2132)

Many farmers' in the developing world predominantly use credit as a form of consumption smoothing. Agriculture production takes time, and the lag between the start of production and the realization of output is often long. Credit transaction therefore permits farmers to consume before harvest. The production is also highly dependent on external factors (e.g. weather) and thus poses a risk to the farmers. In the absence of functioning insurance markets, credit thus enables a relatively stable consumption since income may be highly fluctuating (Bardhan & Udry 1999:76). The need for consumption smoothing and the inability to reduce risk through an insurance market, also effects the farmers' production. In the face of unstable income, farmers tend to prefer technologies and contractual

arrangements that may reduce the mean income, but instead limits the variance of income (Ibid:95). Hence, investments that could increase productivity and consequently increase income may not be undertaken if the expected variance is too high.

The sources of credit in developing countries is often varied and complex but can be characterized as either being formal (banks, government, credit bureaus) or informal lenders (family, friends, local moneylender). In relation to the above discussion of the use of collateral, informal borrowers (even though they may also use collateral) usually have an informational advantage in determining the probability of repayment and also a greater ability to monitor the loan. In contrast to the larger lenders in the formal sector, these information and monitoring advantages enables the lender to use more flexible contracts that are in less need of supplementary institutions to reduce transaction costs (Ray 1998:532-538).

The informal sector is often thought of as dominated by exploitative moneylenders with an ability to charge very high interest rates. This has proven to be the case in many developing countries, but in addition to these lenders, the informal sector also consists of actors with extremely low interest claims (e.g. family or friends) (Ibid:542). Hence, the informal sector may not automatically be attributed high interests rates.

However, some of the benefits exhibited in the informal sector stems from a high degree of segmentation. The segmentation is often due to geographical constraints and may consist of a homogenous set of borrowers (e.g. coffee farmers). This may reduce information costs as described above, but it may also create a lending portfolio of positively correlated loans. In contrast, formal lenders are often able to diversify their portfolio and are not bound to a geographical area. (Besley 1995:2135)

3.3 Connecting the dots

As described in the introductory chapter, many of the impact studies of Fairtrade can be challenged due to their close connection to the organization. In addition to this, most studies focus on the effects on the individual farmers and do not include a broader view of the impact on the market as a whole, and especially not the impact on the institutional environment.

In contrast, there is extensive research of the functioning of the local credit markets and its relation to transaction costs (e.g. Adams & Nehman 1979; Huppi & Feder 1990; Steel et al, 1997). Much of this research has predominantly focused on the role of imperfect information as an important factor for the limited access to credit and the extensive use of informal lenders (Ghate 1992). The functioning of the informal credit market has also inspired new solutions for extending access to credit, e.g. some of the methods applied by microcredit institutions using non-conventional forms of collateral.

But the use of microcredit is not without critics. Some of this critique is in line with the reasoning of this thesis; namely that interventions in the local credit market, although proven efficient in some cases, has to incorporate an impact analysis on the existing institutions (Rogaly 1996). As in the case of Fairtrade, Zohir & Matin (2004) argues that most impact studies of microcredit have focused on the direct effects at the individual/household level and that a wider impact perspective has to incorporate the effects on local markets and the choice of production.

Hence, the analysis in this thesis may also contribute to a broader understanding of how different interventions effect local credit markets.

4 Analytical framework

In order to describe the theoretical consequences of Fairtrade-provided credit, it is important to establish the reasons why this solution is attractive to small farmers in the developing world and why this is a compelling strategy in a world with imperfect information and transaction costs. Starting with the perspective of the producer, the analytical framework is expanded to include the long-term effects on local credit markets.

4.1 Perspective of producer

The following framework for analyzing the choice of governance structure was first developed by Oliver E. Williamson as an extension of Ronald Coase's influential paper "The Nature of the Firm" (1937). According to Coase, the entrepreneur is able to circumvent many of the uncertainties of the price mechanism and reduce costs by internalizing factors of production. Building on the reasoning by Coase, Williamson's analysis can be derived from the description of firms as a "nexus of contracts", organized in a hierarchy (Groenewegen et al, 2010:202). The underlying idea is that the firm in itself consists of a number of contracts that has been internalized due to high transaction costs in the market and stems from the perspective of actors as exhibiting bounded rationality. As described above, both the market and the firm are conceived as an institution of governance, constituting a system of rules that structures transactions between different actors (e.g. between a producer and a buyer or between workers and an owner). Assuming economic actors are optimizing, the minimizing of transaction costs are crucial and consequently the choice of governance structure. For example, should the producer buy important components in the market or produce them himself. Both options are associated with transaction costs (market contracting costs versus bureaucratic costs), and for

an optimizing actor, the task is to determine which option that is more efficient given his or hers preferences (Groenewegen et al 2010:118).

According to Williamson (1991), there are two separate benefits of adaptation connected to each form of governance. The adaptive benefits of the market are derived from the neoclassical ideal where changes in supply and demand are reflected in the price. The autonomous actors of the market are able to respond independently to these price changes and consequently maximize their utility and profits. Thus, the high-powered incentive of the market rewards cost-reducing efforts and allocates resources efficiently.

The adaptive benefits of the hierarchical structure on the other hand are the ability to coordinate adaption to other disturbances than price changes. These types of disturbances may arise because the autonomous actors in the market interpret and react to signals differently or due to contractual disputes. In this respect, the hierarchical structure is more efficient to coordinate actions and to resolve some of the contractual disputes through fiat. The effect of these disturbances increases with bilateral dependency, and consequently the gains of hierarchy (Ibid).

Williamson (1985:52-61) describes three dimensions that effect the decision to internalize a transaction:

- Asset specificity
- Uncertainty
- Frequency

Asset specificity describes the characteristics of an asset in terms of its unique value in the production process. An asset with a high level of specificity will often permit cost savings at the cost of a transaction-specific investment. This investment results in a high level of dependence on the other contracting party, which may abuse the position. In contrast, an asset with a low level of specificity requires a lower level of transaction-specific investments and enables both parties to establish new contracts with new actors in the case of disagreement.

Uncertainty refers to the fact that all transactions involve some level of uncertainty with respect to the behavior of the other party or market developments. Fluctuating market prices and opportunistic behavior are both examples of uncertainties the actor must take into account when trading in the market.

Frequency of interactions effects transaction costs. Regular interactions and dealings between two parties create certain routines and understandings that reduce the need for formal enforcement mechanism. But frequency is also related to production costs through scale economies. Higher transaction volumes may therefore support internalization by reducing the opportunity cost of procuring the same component through the market.

The comparative cost of governance structure as a function of asset specificity is illustrated in Figure 4.1. *Ceteris paribus*, the choice of governance structure is determined by the level of asset specificity through its effect on production cost control, where $B(k)$ is the bureaucratic cost of internalization and $M(k)$ the governance cost of the market and k is an index of asset specificity. Assuming that the high-powered incentives of a competitive market favors lower production costs control, this yield $B(0) > M(0)$. However, as the relative cost advantage of the market decreases for an increase in asset specificity, $M' > B'$ at all levels of k . Denoting the change in governance structure as $\Delta G = B(k) - M(k)$, the relationship can be seen in the below figure. The intersection \bar{k} represents a point where the producer is indifferent between the two governance structures.

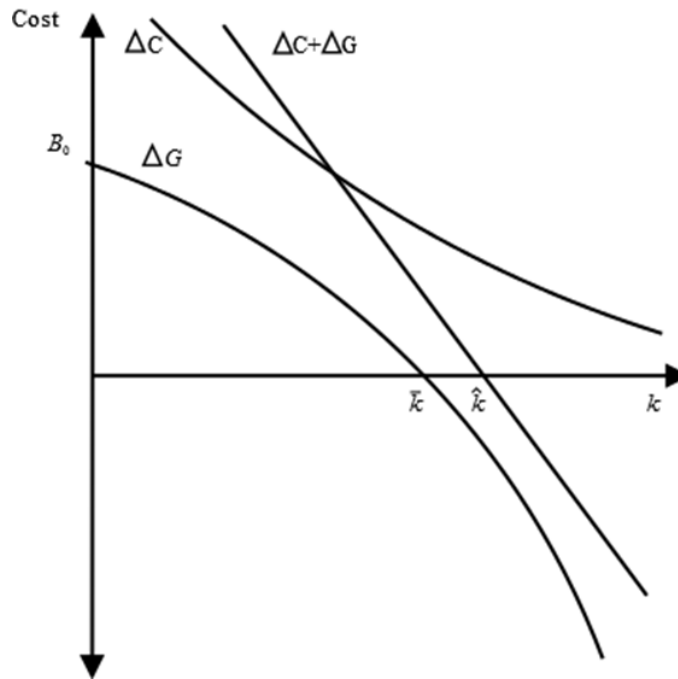


Figure 4.1 Comparative Production and Governance Costs⁵

In order to expand the analysis, Williamson also acknowledges production costs as an important factor, not only governance costs. In this respect, the market is more likely to exhibit economies of scale due to an aggregated diversity of demand.

Describing the steady state production cost difference between producing for one's own need ($P(k)$) and acquiring the same item in the market ($A(k)$) as ΔC , the cost disadvantage of internal production yields $P(k) > A(k)$. But as the nature of asset specificity implies a decreasing economies of scale (due to a lower aggregated demand), this means that ΔC will be decreasing at higher levels of k . Hence the benefits of contracting out in terms of the markets lower production costs is diminishing and consequently reduces the penalty of internalizing production.

Given the level of asset specificity, the objective is to minimize both governance and production costs differences. Summarizing these differences, the intersection \hat{k} in Figure 4.1 describes a new point at which the producer is indifferent between the two governance structures. This point represents a higher

⁵ (Williamson 1985:91)

level of asset specificity than \bar{k} and economy of scale thus favor contracting through the market for a wider range of asset specificity.

But, the choice of governance structure is not as clear cut as the binary concepts of market transaction or internalization. Governance structures may take various forms and sometimes exhibit characteristics of a middle-way, a *hybrid* that incorporates both features of the market as well as the hierarchical structure of internalization.

Assuming that there are no production cost differences, the choice of governance structure is once again dependent on differences in transaction costs. *Ceteris paribus*, the cost of governance structure is determined by the level of asset specificity, and as illustrated in Figure 4.2, the hybrid form, $H(k)$, is the most cost-effective governance structure at medium levels of asset specificity (denoted as all levels of k between k_1 and k_2 .)

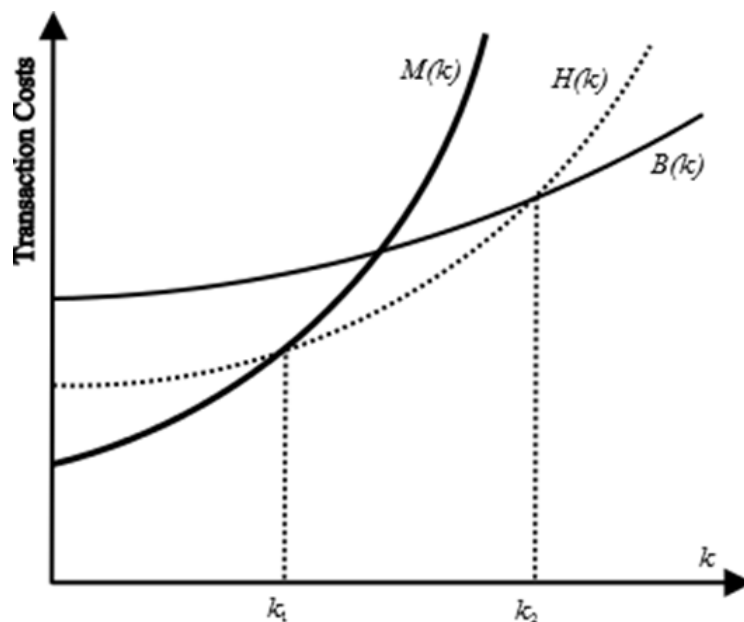


Figure 4.2 Cost of Governance Structures as a function of asset specificity⁶

The hybrid form is essentially a form of contract where independent actors cooperate through an organizational structure. This structure may exhibit varying levels of hierarchical division, but the common denominator for all hybrid form is that the contracting parties partly pool their resources, e.g. personnel, machines or sharing investments (Groenewegen et al 2010:128).

⁶ Based on (Williamson 1991:284)

4.2 Changing the game

According to North (1990), and in line with reasoning of Williamson (1998), governance structures are considered as ‘play of the game’, created as a response to the opportunities provided by the institutional environment constituting the ‘rules of the game’. Economic activity is thus dependent on the available strategies permitted by these rules, and consequently the prospects of economic growth. An analysis of the impact of Fairtrade-provided credit on local credit markets must therefore include the effects on existing strategies and their relation to the institutional environment.

The various governance structures in the economy are purposive entities, designed as a strategy to improve the wealth of their creator. Limited by the institutional environment and other constraints (e.g. technology, income and preferences), they evolve as a means for wealth-maximization (North 1990:73). The economy’s overall performance is thus dependent on institutions through their constraining effect on economic organization.

However, characterized by wealth-maximizing behavior, economic actors are constantly searching for new strategies. This involves finding more efficient solutions within the existing constraints, but it could also mean devoting resources to change features in the institutional environment. The fundamental source of these new strategies is the altered incentives evoked by an endogenous or exogenous change in relative prices (Ibid: 84).



Figure 4.3 Process of institutional change

The starting point of North’s analysis is an institutional equilibrium described as a situation in which, given the bargaining strength of the contracting parties involved, none of the players finds it advantageous to devote resources into

restructuring the agreement. This does not mean that the present solution is preferred, but only that the costs exceed the benefits of altering the agreement. The institutional constraints has thus defined and created the equilibrium. However, with a change in relative prices (exogenous or endogenous), one or both parties may find it advantageous to restructure the contract. Depending on the related constraints in the institutional environment, this may either lead to a new equilibrium within the existing framework, or an attempt from the players to change the rules at a higher level in the hierarchy (Ibid:86). Changing the rules of the game has thus become a viable strategy of the wealth-maximizing actors.

The above description is however a simplified description of institutional change. In order to complicate matters, the analysis must take into account that initial strategies are the result of the institutional environment and consequently new strategies are developed in relation to the old framework. This reasoning relates to the concept of path dependence, meaning that which institutions that will be adopted are highly dependent on previous institutions. Furthermore, the fact that changing relative prices affect incentives does not necessarily mean a move towards institutional change; it may also consolidate the existing framework by altering the relative costs and benefits of future change.

5 Analysis

In order to describe the effects of Fairtrade-provided credit, some assumptions need to be made in order to simplify the analysis. First, all actors are assumed to be wealth maximizing (e.g. subsidized credits through government programs are disregarded). Secondly, farmers are assumed to be autonomous actors allowed to contract as they prefer. This may not always be the case in the real world where many farmers are tenants at the mercy of a landlord. Third, the analysis is assuming different characteristics associated to the formal and informal lenders respectively.

The *formal lenders* are assumed to have access to other markets and thus an ability to diversify risk. Due to a high level of imperfect information, they use a single interest rate for all borrowers in the local market.

The *informal lenders* are in contrast assumed to have nearly perfect information about the risk of individual borrowers and thus able to set individual interest rates. They are however limited to the local market with a homogenous group of borrowers and therefore unable to diversify other forms of risk (e.g. due to weather, diseases or price fluctuations).

Fairtrade-provided credit is defined as the low-interest loans provided by the cooperative and the possibility to receive payment in advance. The additional access to capital by the premium for investments in the production and the minimum price, are for simplicity reasons also regarded as credit since they constitute a contractual arrangement that substitute the need of procuring this capital through the credit market.

5.1 Internalizing access to capital

Even though an important aspect of Williamson's description of asset specificity is based on its characteristic as a unique factor of production requiring transaction specific investments, the logic behind his reasoning may be applied to capital in local credit markets. Even though fully internalized production of capital may be thought of as the producer only relying on savings, this analysis focuses on the access to credit as the determinant factor. Since fully internalized production of capital is not a practical option, the internalization process is thought of as adopting a new governance structure with higher bureaucratic costs in exchange for access to credit.

As described in section 4.1, the choice of governance structure is highly dependent on the three dimensions: asset specificity, uncertainty and frequency. The analysis starts with describing access to capital in developing countries from the perspective of these dimensions.

- *Asset specificity.*

First of all, the argument of internalizing highly specific assets is based on the increased risk resulting from bilateral dependency. Assuming a minimum of at least constrained competition in local credit markets, producers are consequently experiencing a high level of dependency on creditors.

Secondly, capital as a factor of production for farmers in the developing world is predominantly used for consumption smoothing. It is more than improving the present by repayment in the future. It is about eating today and surviving tomorrow. The access to credit is thus a vital part of production.

Moreover, Williamson focuses on the transaction-specific investment involved as a determinant of risk. Using the lowered expected return of a loan when adding collateral as a measurement of investment, the transaction-specific character of this investment is determined by the risk of losing it *ex post* the signing of a contract. In an institutional environment characterized by weak property rights and a dysfunctional judicial system, this poses a risk to borrowers required to put up collateral. Hence, even if the borrower would be able to acquire capital at a

lower interest rate on the local credit market by presenting some form of collateral, this may not be an attractive strategy due to the risk of opportunistic behavior of the lender.

- *Uncertainty*

Fluctuating market prices, weather, disease and other exogenous factors all determine the farmer's income. These fluctuations may present a direct threat to the livelihood and survival of the family's, even if income on average is high enough to support a minimal standard of living. In the absence of functioning insurance market, Fairtrade is thus an attractive strategy for reducing these risks by the offered minimum-price and increased access to consumption smoothing credit.

- *Frequency*

More frequent transactions lowers transaction costs by reducing the need for formal enforcement mechanism. It is essentially the establishment of a relation where one of the determinant factors for reduced costs is trust. From this perspective, the farmer's decision to join the Fairtrade cooperative is also affected by its reputation of honoring the agreement.

Furthermore, Williamson argues that the decision of internalization in terms of frequency is not only linked to transaction costs, but also on its relation to economies of scale and consequently production cost. From this perspective, the market is assumed to have lower production costs due to an aggregated demand and the price of procuring through a competitive market should therefore be lower than the cost of internalizing production. However, in the competitive credit market (assuming no transaction costs), the price of capital is dependent on the risk premium demanded by the lender, effected by his or hers ability to diversify risk. In this respect, the risk premium of Fairtrade-credit is absorbed by the higher price paid by the consumer. Consequently, without accounting for transaction costs, the price of Fairtrade-credit will always be lower than the price of credit in the market.

Summarizing the above dimensions, it can be concluded that Fairtrade should always be able to offer a lower interest rate than the market even in the absence of transaction costs. Furthermore, due to high contracting costs in the credit market, the farmer has incentives to find an alternative governance structure. If Fairtrade is a viable strategy or not is thus dependent on the bureaucratic cost.

The bureaucratic cost of joining the Fairtrade cooperative can be described as twofold. First of all there is the direct cost of membership. Secondly, due to the Fairtrade standards, the producer may need to adjust aspects of the production (e.g. increase wages or change to a more expensive fertilizer). Both of these costs are highly transaction specific and would not be undertaken in the absence of Fairtrade. Hence, the reputation of Fairtrade honoring the agreement is very important since the farmer's ability to monitor and enforce the contract is very limited.

Since Fairtrade is limited to the production of a certain crop, the above analysis has made the assumption that prospective members are producing this crop. However, since the farmers are wealth-maximizing, they may find it advantageous to switch their production to the crop certified by Fairtrade. The decision to do so is based on a cost-benefit analysis and can be said to follow the above reasoning but with a higher cost of internalization due to additional investments.

5.2 Fairtrade - The game changer

In line with the argument of North, the change in governance structure is due to a change in relative price between internalizing access to credit and contracting through the market. With Fairtrade providing access to credit below the cost of procuring it through the market, it has become an attractive choice to farmers. However, the initial change in relative prices does not only affect the producers, it also alters the strategies of lenders. How they respond will determine the producer's final choice of either contracting through the market or internalizing the access to capital through Fairtrade.

Without alternative means, the lenders must respond with a lower-interest rate with the minimum requirement of making the producer indifferent between Fairtrade and contracting through the market. Starting with a scenario where the lenders are in a competitive market, the analysis is divided into the response of the formal and informal sector respectively. Furthermore, the formal sector is assumed to have one single interest rate for all borrowers, while the informal sector is able to discriminate between high and low-risk borrowers.

Formal sector – perfect competition

Given that the impact of Fairtrade has not enabled any new strategies of lowering the transaction costs of lending, the only possible strategies for the lender are to find other investment opportunities, maintaining the present interest or lower the interest by reducing the risk premium. Since profits are already exhausted by the competitive market, a lowered risk premium would yield a negative expected return and is therefore not a viable strategy for a wealth-maximizing actor. Assuming the formal creditor is active in other markets than the local, the remaining strategies are thus to find alternative investment opportunities or to keep the present interest rate.

Informal sector – perfect competition

Since the logic of a negative expected return holds for the informal sector as well, reducing the interest rate is not an option if the market is competitive. In contrast to the formal sector, the informal is assumed to be limited to the local market and has no alternative investment opportunities. Hence, the only viable option is to maintain the present interest rate or to stop lending.

Formal sector – market power

As in the case of perfect competition, the lender is not expected to be able to lower the interest rate by lowering transaction costs. Since the lender has market power and consequently makes a profit, the decision to lower the interest rate to a competitive level is dependent on the expected return and the return of alternative investments.

Informal sector- market power

The response of a lender in the informal sector with market power is identical to that of one in the formal sector; except the ability of finding alternative investments. Hence, lenders in the informal sector will lower their interest to a competitive level or until all profits are exhausted.

Summarizing the above analysis in terms of initial interest responses, the only possible strategy of lenders in a competitive market is to maintain the current interest. In the case of lenders having market power, they may either lower their interest to a competitive level or if this is not possible without a negative expected return, maintain the current interest.

Starting with the scenario of perfect competition in which lenders are not able to lower their interest rate, this strategy can be described as strictly dominant since maintaining the interest always yields a higher pay-off than lowering it, regardless of what the producer choose. The pay- offs for the initial strategies are illustrated in Figure 5.1.

		Lender	
		Maintain	Lower
Producer	Not join	1 1	-1 3
	Join	0 3	-1 2

Figure 5.1 Pay-off matrix for scenario in which lenders are not able to lower their interest⁷.

The farmers’ decision to join Fairtrade is also self-sustaining. As described previously, one of the bureaucratic costs of internalizing capital through Fairtrade

⁷ The pay-offs are estimated as relative costs and benefits. Farmers are assumed to get the same benefit as with Fairtrade if lenders lower their interest. However, if lenders lower their interest and the farmer joins Fairtrade the pay-off is relatively lower since there are costs associated with Fairtrade that would lower the utility in the present of lower interest in the credit market.

is the membership fee. Since this fee will be lower with more members, the relative cost of contracting through the market will continuously increase.

Furthermore, if the main reason to join the cooperative is to reduce risk, the farmers deciding to join Fairtrade would tend to be the most risk-averse. Assuming that these farmers' are also among the low-risk borrowers, this will affect the single interest rate in the formal sector. Since the formal sector has a single interest rate due to the inability to discriminate borrowers in terms of risk, their expected return will decrease when the low-risk borrowers join Fairtrade. Hence, the formal sector will find an alternative investment in another market or the interest rate will go up. Both actions increase the farmers' incentive to join Fairtrade. The same effect is however not present in the informal sector since these lenders have adjusted their interest according to high and low-risk borrowers.

In the case of lenders having market power, there are two possible scenarios. In the first scenario, the lenders are not able to lower the interest to a competitive level due to a negative expected return. The process is similar to that in a market of perfect competition but not necessarily with increased interest rates in the formal sector. As low risk-borrowers start acquiring Fairtrade-credit, the lender will have decreasing profits due to a lower return, but will retain the interest until all profits are exhausted or until there is a higher expected return of alternative investments. Since lenders in the informal sector are able to separate between high and low-risk borrowers they will retain their interest rate and keep lending in the absence of alternative investments. Farmers prefer Fairtrade-provided credit to the high interest in the market and will continuously join Fairtrade.

In both cases where local lenders are unable to compete with Fairtrade, these lenders will gradually leave the local market.

In the case of lenders being able to adjust their interest to a competitive level, the lenders will, in the absence of alternative investments with a higher return, set an interest rate that is more attractive than the Fairtrade alternative if possible. If not, farmers will be indifferent between joining Fairtrade and procuring credit through the market. In both these scenarios the main effect is an income

redistribution between lenders and borrowers due to the introduced competition of Fairtrade.

5.3 Fairtrade and path dependence

Following the argument of North, the change in governance structure will generate a new equilibrium within the existing institutional environment. An additional change in the institutional framework, the ‘rules of the game’, is dependent on the involved actors expected costs and benefits of dedicating resources to restructure these institutions. Separating the involved actors as either being farmer, informal lender or formal lender, the expected consequences in the above described scenarios are as follow:

Local lenders unable to compete with Fairtrade

In this scenario, regardless of initial market power or not, farmers will experience relatively lower utility of altering the institutional environment. The introduction of Fairtrade has provided an improvement and consequently lowered the expected benefits of altering the framework.

Formal lenders are expected to have alternative investment opportunities. Hence, even though their incentive to alter initial framework has increased, the associated costs are expected to be higher than the potential benefits since they have alternative investment opportunities. In the absence of other options, these actors will leave the local market.

Informal lenders are the actors with the highest incentive to alter the institutional environment since they do not have alternative investment opportunities. However, the cost of altering the framework by them self is expected to be too high. So in the absence of a coordinate strategy with other actors this is unlikely. Furthermore, this type of coordinated strategy is unlikely since the informal lenders and the two other groups of actors are expected to have deviating goals. This is due to the fact that the informal lenders were benefiting from the high transaction costs that constrained the formal credit market.

Summarizing the changed incentives as a consequence of Fairtrade, there are no actors with the incentive or ability to change the rules by themselves. However, these incentives may change due to exogenous factors.

As described in the previous section, the incentive to join Fairtrade increases as interest rates goes up and the bureaucratic costs goes down. This means that farmers producing a different crop (crop A) than that of the Fairtrade cooperative (crop B) at some point find it more beneficial to switch production and join the cooperative. This effect has two consequences. First of all, in the absence of Fairtrade, these farmers had chosen a different crop since this would yield a higher income. This means that they were most likely more productive when farming crop A, otherwise they would have chosen crop B from the start. Secondly, if there is a change in the long-term demand for crop A, farmers might find that they would receive a higher income by leaving the Fairtrade cooperative and switch production. However, due to the changes in the credit market this may no longer be a possible strategy, either because interest rates are too high, or because all lenders have left the market. The farmers are thus “locked-in”, and must continue producing crop B. In this case, the farmers’ incentive to change the institutional framework has increased, but a coordinated strategy with the formal lenders may not be possible since these have left the market.

Hence, the introduction of Fairtrade may not affect the ‘rules of the game’ but could create a new equilibrium from which the cost of altering the rules is even higher.

Local lenders able to compete with Fairtrade

As described in the previous section, the main effect in this scenario is an income redistribution between lenders and borrowers. From this perspective, the farmers’ relative benefits of altering the rules have decreased. However, due to the income redistribution they have also gained more economic and political power. This could be translated to a lowered cost of altering the rules. Thus the incentive to change the rules is potentially higher.

The formal lenders are the ones with the highest incentive to alter the rules. With decreasing profits in the local market, the relative benefits of changing rules higher up in the hierarchy increases. They are therefore willing to devote more resources than previously to change the institutions. Moreover, this is also

assumed to be the actors with the best ability promote change due to a higher economic and political influence and greater knowledge of how the institutions work.

The informal lenders have also had decreasing profits, but as in the former scenario, this group benefits from the high transaction costs that constrains the formal credit market, and thus a coordinated strategy with formal lenders are highly unlikely.

In this scenario the ability to change the institutional framework has increased or is unchanged. The reason why it may increase is twofold: First, due to the income redistribution, farmers has become a more powerful collective with an increased economic and political influence. Secondly, even though their incentive to change the rules may be unchanged, the incentives of formal lenders have increased. If working together, they may be able to restructure the rules.

Even though the complexity of changing the institutional environment makes it almost impossible to analyze, the above analysis provides a suggestion to how the necessary incentives might have changed due to Fairtrade-provided credit. An important aspect that has not been included in this analysis is the assumption of actors exhibiting bounded rationality. From this perspective, the changed incentives as described above should be interpreted as how they *should* change. Actors may not be able to coordinate their efforts or they may not know which rules to change.

6 Conclusion

As described in the analysis, the effect of Fairtrade on local credit markets is highly dependent on the level of competition and existing constraints. If Fairtrade is introduced in a competitive credit market it is likely to force existing lenders out of the market, but if the lenders have market power Fairtrade may lead to an income redistribution by imposing competition and thus force the lenders to lower their interests. Furthermore, the impact of Fairtrade may affect the involved actors' incentives to devote resources in order to change associated institutions higher up in the hierarchy. Once again this is dependent on the initial conditions and constraints. The analysis concludes that the incentives for altering these rules are potentially increased if Fairtrade pressures the lenders to lower their interest; but that these incentives may also be lowered if Fairtrade forces existing lenders out of the market.

In summary, the effects of Fairtrade are highly dependent on the initial conditions in the local credit market. In terms of policy implications, this means that Fairtrade's uniformed recipe for improving the life's of small farmers may have negative consequences in the long run. Returning to the initial metaphor by Hayek, this would mean that the highway has replaced the beaten track without being a more efficient way from point A to B. Instead it generates a dependency as the forest slowly grows and continuously increases the relative price of finding a more efficient path.

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