Discussion Note

"Relationship Fair Wages and Socio-economic development"

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Introduction

Payment of fair wages can have effects on both macro- and micro level. It is useful to make a difference between the situation in which only 'fair trade' companies raise the salaries and the situation of a general raise in wages. Here we will discuss the case of a rise in wages in 'fair trade' companies only.

Suppose a situation in which in a specific region wages of fair trade companies are raised to a level above the common paid wages and achieve the level of a 'living wage'. Living wage is here defined as the wages that are sufficient to enable the worker at least a decent life for himself and for his family. So this includes education, health care, shelter etc.
Suppose as well that the bulk of the production is exported; the part that is sold within the country itself is small.

We have to distinguish between economic and social effects. Economic effects include the effects of higher wages on purchasing power, turnover, profits and employment. Social effects not only include effects on the health of the workers and their families, possibilities to schooling for the children and in general 'welfare' effects, but also the widening of the gap in income between workers employed by different companies within and outside the fair trade sector.

Economic effects

Purchasing power
A rise in wages leads to more purchasing power for the workers involved. This has its impact on the economy. Because of the rise in income demand for goods gets a boost. What is important for the economy is to know which demand for what goods rises. Take a family that before the rise in wages did not have enough to eat. Probably they will use a great part of the additional income to purchase more, or better, food. After that, other products will follow in order of preference. Trade in these specific products rises and that way shopkeepers have a larger turnover and local producers can produce more, as long as domestic products are consumed. If however, most of the additional wages is used to purchase foreign goods, the way the local economy profits is much less because only the retailers profit and not local industry. In that case a great part of the wages leaks away.

The effects of a rise in wages in the fair trade sector only are limited. Production of fair trade goods as a percentage of total production in a country is usually so low that the effects at national scale can be more or less neglected. At local level the situation may be different though. For village and rural shops an increased consumption level of a number of families can make a difference. How much difference, depends on the level that fair wages have been applied. The more companies pay a fair wage to their workers, the more the local economy profits. What makes this case the more interesting is our assumption that most of the fair trade products are exported which means that it is not the local economy that pays for the higher wages but consumers in the importing countries do.

Turnover

What will be the effects on turnover, profits and employment? All variables are linked. A diminishing turnover leads to less production, fewer profits and less employment while a higher turnover, when techniques remain the same, leads to more profits and employment. So we must pose the question what the effects of higher wages in the fair trade sector on profits and employment will be as well. Higher wages in one firm will normally not lead to a higher turnover of that same firm.

So at first glance one would conclude that turnover will be less because consumers prices will rise because of higher wages paid.

There are a number of arguments however, that indicate why higher wages will not always result in a lower turnover.

1. Consumer prices for a number of products in Europe can be raised when production is destined at a niche in the market. People are willing to pay more an exclusive product.
2. A rise in wages does not in all cases necessarily lead to much higher prices for the consumers. This requires a different way of calculating the consumer price, namely by not working with percentages in the chain but with fixed prices. Annex I gives a very simplified model showing the differences in consumer price when calculations are done with fixed amounts instead of percentages.
3. Costs, and that way prices, can be lowered by more cooperation in the fields of transport, both national and international, and storage. This may take the form of e.g. common warehouses, common use of a container to ship goods and the mutual use of the same exporter.
4. Many fair trade customers purchase fair trade goods because they are convinced that a producer deserves a fair wage for his labour. Those people will not purchase less when prices rise with a modest amount. On the contrary, they will stop purchasing when they learn that producers/workers do not get a fair price / fair wages. In contrast to this group of customers there is a group of customers who do not purchase out of conviction, but just because they like the product. For them too high a customer's price may be a barrier. This depends on the elasticity of their demand.

Arguments 1, 2 and 3 show that higher wages do not automatically have to result in a lower turnover. Argument 4 on the contrary shows why the turnover might fall. The question is whether this can be made up for by applying the recommendations for improved cooperation and calculation methods in the chain, as implied in arguments one to three. It is not possible to formulate general rules; for each situation and each product the situation can be different.

Profits

If turnover does not fall, what happens to profits since wages are higher now than before? If techniques used in the production phase and prices of intermediate goods remain the same, profits will fall, unless the benefits generated by more cooperation in the chain and better adjustment to changing demand, makes good for this fall in profits. Important in this respect is to what extent the producer is able to invest in better techniques. Here the possibilities of credit and support by importers are important.

Employment

Above mentioned arguments seem to indicate that payment of a fair price does not necessarily lead to a dramatic rise in consumer prices and therefore to a great loss in turnover. What it does lead to, is a change in production costs with a higher cost for labour.
So even if the effects on employment because of a change in turnover are minimal, changes because of higher remuneration of labour may lead to pressure on the number of workers.

It is possible that a producer invests in labour-saving techniques because wages get too high. In that case often better skilled labourers will be needed who normally have to be better paid as well. These investments, if well managed, may lead to a better position in the market however. This might have as effect an increase in demand for labour.

So it will be very difficult to indicate what the result will be of higher wages on employment, even when the chain gets better organized.

Social effects

Here we can distinguish between effects for a. the worker and his/her family, and b. the effects on their environment.
ad a. A rise in income is normally welcomed by the worker and his family involved. They cam afford themselves and their family better and healthier food, better treatment in case of illness and schooling for the children. In short: both more welfare and more well-being.
ad b. in some instances you might say that an island is created of 'fair' paid workers in the middle of a mass of underpaid workers. This may create jealousy with the other workers but might as well have a positive effect on other employers and employees because they see that the payment of a fair wage is possible.

Conclusion Economic and Social effects

On basis of this we can come to the following conclusions:

1) uniform conclusions cannot be drawn because each situation and each product is different and requires a separate analysis,
2) it is not possible to predict the outcome of a rise in prices as a consequence of higher wages on consumers' behaviour. Part of the consumers will leave because of the higher price; other customers will remain because they find better working conditions important. They might even leave if no living wages are paid to the workers
3) turnover may diminish, but this can be stopped and even reversed by more cooperation in the chain and another way of calculation of the consumer price
4) purchasing power of the workers grows which may have a positive effect on the local economy
5) profits for the producer are likely to diminish because of higher remuneration of the factor labour
6) employment effects are likely to be negative for unskilled and low-skilled labour, but may be positive for higher-skilled workers
7) more welfare and well-being for the workers whose wages have risen
8) demonstration effect on other companies and employees.

Annex I

This is a very simplified model showing the differences in consumer price when calculations are made with fixed amounts instead of percentages. Please note that this model does not reflect any existing situation, it is merely a model to show how different ways of calculation can have different results.

Description		Initial wages of 20 € €		Doubling of wages, other costs in percentages €	Doubling of wages, other costs fixed €
Material		20		20	20
Labour		20		40	40
Rent		5		5	5
Other costs		5		5	5
Total production costs		50		70	70
Profit	10%	5	10%	7	5
Subtotal		55		77	75
Transport	15%	8	15%	12	8
Subtotal		63		89	83
Shipping and Handling	20%	13	20%	18	13
Subtotal		76		106	96
Transport and handling costs country of destination	5%	4	5%	5	4
Storage	5%	4	5%	5	4
Subtotal		83		117	104
Profit importer	20%	17	20%	23	17
Subtotal		100		140	121
Costs and profit retailer	30%	30	30%	42	30
Subtotal		130		182	151
Taxes 10%	10%	13	10%	18	15
Consumer price		143		201	166

As can be seen, an initial part of labour in the production costs of 20 €, leads to a consumer price of 143 €.

When wages are doubled, from 20 to 40 €, consumer price rises to 201 € when the same method of calculation, with percentages, is used. A raise in consumer price of 58 €.

However, when the amounts that have been fixed initially as being sufficient for all other partners are used, the consumer price will only be 166 €, a raise of 23 € instead of 58 €.

So a rise of wages at the beginning of the chain from 20 to 40 €, leads to a price raise for the consumer of 23 € only.