

Political Economy and Private Governance

In situations of conflicting interests

Questions—Some Addressed and Some Not

- Where will self-regulation and private governance occur and when?
 - Which firms and industries and where (e.g., countries)
- Under what circumstances will it occur?
 - Purely voluntary--CSR
 - Under social pressure from public or private politics
- What form will it take and who participates?
 - Industry only (SFI), individual firms [Nike]
 - NGOs only (WRC) (FSC)
 - Mixed
 - Participation: voluntary [Responsible Care], screening [Equator principles]
- What are its operating characteristics?
 - Standard setting
 - Monitoring/inspections
 - reporting
- How well does it perform?
 - Absolute: e.g., social benefits and costs
 - Relative to:
 - Government regulation
 - Market forces
- What lessons can be learned about what went well and poorly?

Overview

- Politics
 - Public
 - Private
- Political Economy
 - Structured model
 - Behavior and outcomes
- Private Governance
 - Challenges from a political economy perspective
 - A pervasive problem

Public Politics

- Public politics ~ government-directed social pressure
- Setting (some of) the rules of the game
- Same method as economics
- Preferences of officeholders
 - Self-interest/re-election
- Behavior is structured by public institutions
- Central issues
 - Voting systems and quotas
 - Interest group influence
 - Collective action/free-rider problems
 - Delegation and discretion
 - Enforcement through the courts—public or private litigation
- Public politics can be blocked; e.g., gridlock
- Public politics can be strategically forestalled; e.g., by self-regulation (to the boundary of the gridlock interval)

Private Politics

- Privately-generated social pressure directed at private economic agents
 - Activists and NGOs are the agents of interest groups (e.g., unions) and motivated citizens—who may not automatically free-ride
- Private politics could be a substitute or complement to public politics
 - E.g., wages for fast food workers
 - Focus here is on actions (largely) independently of public politics
 - The shadow of public politics can have an effect; e.g., courts
- Citizens can offer demand-induced incentives
 - Buying green goods and not buying brown goods
 - Even if there are rewards, are they dissipated through competition?
 - This is largely driven by market forces
- Much of private politics is confrontational—threat and reality of harm
 - Firms or industries are typically the target
 - Activists have an advantage due to the “trust gap”
- Self-regulation is induced by the threat
- Activists (some) are special interest groups with outlier preferences
- What may appear to be cooperation may be a (potential) target inviting an NGO to “help” implement its self-regulation

Structured Political Economy Model

- How do we model private politics when there are no formal institutions to structure the game?
 - Reduced-form models of outcomes--contest functions and all-pay auctions
 - Structured models (canonical models of private politics)
- A social issue; e.g., environment, labor standards, redistribution, privacy
- A population of potential targets, e.g., vulnerable firms or industries
- A collection of activists that vary from supporting to moderate to radical
- Participants in the market for activism are purposeful /rational
- Some motivated citizens (and interest groups) donate to fund activists based on their anticipated consequences
- Campaign (analogous to an “institution”)
 - An issue-specific demand by an activist to all potential targets and a threat of action—a campaign that harms a target (reputation, brand equity, employee morale, ...)
 - Reliance on the (friendly) media—social and traditional—and the Internet
 - Self-regulation opportunity for potential targets
 - Purpose of self-regulation is to create a shield/ to forestall harm
 - Activist selects a target and either accepts the self-regulation or campaigns
 - Firm may act to counter a campaign--difficult
 - Firm concedes and the activist goes away or firm refuses and incurs harm
- Compliance typically is assumed; e.g., self-regulation is assumed to be irreversible
- Rational expectations—expectations of donors agree with anticipated accomplishments

Specification

- Donors fund activists
- A firm has vulnerability to a corporate campaign and an activist cannot commit not to exploit that vulnerability [activists prefer softer targets]
- There are fewer activists than firms
- Firms self-regulate (based on their vulnerability) because of the threat of a harmful campaign
 - Activists thus have leverage over a large set of firms
- Activists target a subset of individual firms with a campaign
- Probability that a campaign succeeds is increasing in vulnerability
 - Because of trust gap, firms have difficulty communicating their good deeds
- Private politics has effects at three levels
 - Many more firms are threatened by activists than can be targeted—leverage
 - Firms engage in precautionary self-regulation
 - Some firms are engaged by activists and others are not
 - For the engaged, activist accepts the self-regulation or campaigns (could bargain)
 - Firms have a degree of safety in numbers
 - Firms that are targeted weigh the harm against the cost of change
 - Resist, concede, bargain depending on the specifics of situation

Behavior and Outcomes

- Greater self-regulation is required from a more vulnerable firm
 - more vulnerable firms must self-regulate more because the activist can extract more from them in a campaign
- Hard firms find it cheaper to self-regulate than do soft firms
- Some soft firms find the required self-regulation too costly and choose to incur a campaign. These soft firms anticipate a campaign and profit-maximize
- Why can't the activist commit to accept less?
 - Reputation might work except for the private politics hold-up problem
- Campaigns thus are waged against soft firms that profit maximize and hard firms self-regulate
 - They self-regulate more the more vulnerable they are
- Radical activists target harder firms than do moderate activists
- Some firms are too hard for a corporate campaign to succeed, and they maximize profits
- These firms can be vulnerable to market campaigns that target firms in their supply or distribution chains; e.g., Home Depot
 - The rise of market campaigns

Private Governance

- Firm or collective self-regulation to forestall private politics [Nike, Wal-Mart]
 - Self-regulation forced on suppliers [Wal-Mart]
- Self-governance through moral commitment (CSR)
 - Evidence is mixed at best and weak
- An agreement among “opposing” private politics parties
 - Examples: FLA, SFI
 - Firms want a shield against further social pressure
- Some activists go it alone [FSC, WRC]
- Governance arrangements are non-cooperative
 - Cooperation might be a firm joining with NGOs with expertise
 - That is, cooperation is joint search for Pareto improving alternatives [McDonald’s and EDF]
- Enforcement is through
 - Self-interest [Nike]
 - Noncooperative equilibrium [Wal-Mart, McDonald’s]
 - Threat of resuming private politics
 - Shadow of government—possible alternative of public politics
- Firms refuse to sign enforceable agreements or to participate [ISO 14001]
 - Agreements are constrained by the threat of liability and the possibility of opportunistic legal action, particularly in the U.S.

Challenges to Private Governance

- Ex ante impediments to multi-party private governance arrangements
 - Competitively valuable information could be disclosed
 - Heterogeneity among firms in an industry makes agreement difficult
 - Activists and firm speak different languages—some hire interpreters
 - The trust gap means that outsiders remain skeptical at best (shield may be weak)
- Activists do not aggregate
 - Firms want to be judged on what they accomplish in the aggregate [Wal-Mart]
 - Activists want any “bad” to be eliminated (even if it is offset by many “goods”) [Domtar]
- Agreements that improve monitoring by activists or reduce their enforcement costs also strengthen their bargaining power
 - Social media aids in monitoring
- Formal agreements could be challenged in the courts
- Ex post: Enforcement
 - Imperfect information makes monitoring difficult
 - Independent monitoring could be risky for a firm
 - Achieving compliance is difficult even for Nike
 - Capture –by either activists or firms
- Sanctions
 - Information disclosure (e.g., inspection reports) may have limited effectiveness
 - Monetary sanctions are rare (who would determine the amount?)
- Agreements are limited by a private politics hold-up problem
- What does government do better than private politics? [Michael Brun]

Private Governance: Internal Issues

- Participation
 - Voluntary? Who joins? [Responsible Care]
 - Those that meet some criteria?
 - Who chooses the criteria?
 - An industry association [SFI]
 - 4 banks that led the Equator Principles
 - Under what conditions can a member exit?
 - Can members be expelled?
 - Are NGOs or others members? Will they be viewed as captured?
 - How is the organization funded?
- Tradeoff between the stringency of standards and number of participants
- Decision-making—how are standards set and changed?
 - Decisiveness rule: unanimity, (super) majority rule
 - Unanimity gives numbers but the lowest common denominator prevails
 - Every group has a veto [FLA]
- Sanctions
 - Who decides? [FLA “court”]
 - Form: Information disclosure, fines, expulsion
- Can credibility be established given the trust gap; i.e., is there a shield?

The Private Politics Hold-Up Problem

- Set-up
 - (Some) activist(s) and (some) firm(s) reach an agreement [SFI]
 - Firm makes a public pledge (perhaps conditional on circumstances [Ford])
 - Firm participates in NGO system [Domtar and FSC]
- Agreement does not preclude public or private politics by non-signatories
 - Everyone has standing to intervene
- Nothing prevents more extreme activists from attacking the firm(s) or the agreement
 - Private politics social criticism or campaigns
 - Media campaigns
 - Pressuring customer-by-customer [FSC backers]
- Critics can turn to public politics
- Lawsuits can be filed
 - Legitimate or extortion
- Consequently, an agreement may not provide a strong shield even when the private governance arrangement works [SFI, FLA]