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The microeconomics of strategic activism

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Chapter 1

Introduction

Increasingly, considerations regarding the ethical and environmental conduct of firms play an important role in the purchasing decisions of consumers. The proliferation of product labels claiming that the product's supplier has abided by certain ethical or environmental standards illustrates the ascent of *ethical/green consumerism.* This green consumerism has been fueled by attempts of interest groups, e.g. environmental groups, to affect economic activity by means of *private politics* (Baron, 2001, 2003).[1]

An interest group (IG) is said to engage in private politics if it tries to change the practices of market participants without recourse to public institutions or office-holders. Examples include informing consumers about the harmful practices of firms, initiating a consumer boycott, bringing social issues to the public's attention, and lobbying firm executives.[2] With private politics an IG seeks to mitigate the effects of some objectionable enterprise one or more firms engage in. Of course, IGs can also resort to *public politics* to try to mitigate those effects. In that case an IG tries to change the practices of market participants indirectly via public institutions or officeholders, for instance, by lobbying policy makers for regulation.

The recent surge in *corporate environmentalism* (Lyon and Maxwell, 2004), i.e. business-led environmental initiatives, is partly caused by the threat of public and private politics contrived by IGs.[3] Indeed, Maxwell et al. (2000) find empirical evidence that a more prominent presence of environmental groups induces firms to reduce toxic releases. It is not only the mere threat of IG activism that affects firm behaviour. The case studies presented in Spar and La Mure (2003) convey that IGs

[1] We skip the adjective "ethical" from now on to avoid lengthy sentences.

[2] Some case studies can be found in Spar and La Mure (2003).

[3] The possibility that firms overcomply with environmental regulation in order to reap the benefits from green consumerism, a more direct reason to engage in corporate environmentalism, was first discussed in Arora and Gangopadhyay (1995).

are willing to spend considerable time and resources to 'convince' firms to green their behaviour. Friedman's (1999) discussion of IG-orchestrated consumer boycotts indicates that such boycotts, a commonly employed tool of private politics, can last for years and that over one third of the boycotts ultimately affect firm behaviour.

Although the impact IGs have on market outcomes is thus often considerable, the microeconomics literature has not yet provided satisfactory, microfounded explanations for the incidence of various types of private politics. In fact, as we explain below this literature has difficulties explaining the fact that certain types of private politics do occur in the first place. The main goal of this thesis is to provide microfounded explanations for the use of various instruments of *strategic activism*, i.e. the private and public politics of IGs.

The theoretical models we develop shed light on several questions related to the impact IGs can have on markets. To what extent are IGs able to change the targeted firms' behaviour? When is strategic activism most likely to occur? How does it affect welfare? When is using strategic activism the most promising route to the desired change?

Research questions related to strategic activism have only recently caught the attention of economists. The literature on strategic activism is thus in its infancy and consequently does not yet offer comprehensive theories answering the above questions. Importantly, the papers in which IGs do initiate a campaign by and large neglect the considerations of individual consumers or firms: IGs simply have exogenously given devices at their disposal with which they 'persuade' firms to cater to their wishes. So, an IG is able to steer consumers away from targeted firms should these discard its demands, but the mechanism driving this behaviour is not spelled out. Most authors who do specify the preferences, possibilities, and constraints of agents in full detail conclude that any activism is preempted by firms or that firms and IGs settle any disputes as soon as possible. The argument goes as follows.

Of course, a firm would simply acquiesce to an IG's demands if these could be costlessly met. Now suppose that meeting an IG's demands is costly. Then a profit-maximizing firm fully aware of the pending decline in its profits should it cast aside an IG's request for change employs the following, simple rule. Meet the IG's demands if and only if the associated costs do not exceed the decline in profits it faces when ignoring the IG's request. Clearly, the firm has no reason to postpone the decision whether to acquiesce to the IG's demands if it knows the associated costs and benefits. In fact, it is conceivable that a firm preempts any activism by 'greening' its behaviour before it catches the attention of an IG.[4] This reasoning

[4] Indeed, preemption is a recurring theme in the literature on strategic activism. See for instance

suggests that instances of private politics either do not occur or if they do occur, then they do not last long.

A similar reasoning applies to an IG's considerations. If an IG knows that it lacks the means to inflict sufficient harm on a given firm's profits to bring about some desired change, then it is optimal for this IG to refrain from costly activism directed at the firm under consideration or at least revise its strategy. A well-informed IG will therefore only make demands to firms that will be met, suggesting again that conflicts between IGs and firms are short-lived.

In reality though campaigns by IGs sometimes last years and might even turn out to be in vain.[5] This observation suggests not only that it is costly for firms to adopt the demanded changes, but more importantly that either the target of private politics or the instigator of private politics is ill-informed about its rival's characteristics. An IG need not know how difficult it is for firms to better their behaviour, whereas firms need not know how much impact the IG's activism can have on its profits. A theory of private politics that strives to explain the observed impasses surrounding IG activism must thus feature some kind of *asymmetric information*.

The reason an IG might wield some power vis-à-vis firms has already been mentioned in the first paragraph. An IG's actions would be futile should consumers not care about the issue at stake or remain callous as the campaign unfolds: a pure profit-maximizing firm is best off ignoring any IG activism if such disregard bears no consequences in the marketplace. Some form of (dormant) green consumerism seems therefore an inevitable ingredient of a theory of the private politics of IGs.

In this thesis we take as a starting point that in a world with perfectly informed, rationally acting agents with stable, neoclassical preferences private politics would be redundant. To explain the pervasiveness of private politics, we therefore employ models which depart from this paradigm in ways that have been alluded to in the previous few paragraphs. Green consumerism and asymmetric information thus take centre stage in the chapters dealing with private politics. Starting from explicit objective functions for all relevant agents (consumers, firms, and IGs), we show that in the presence of green consumerism and/or informational asymmetries the types of strategic activism under consideration do occur in equilibrium and that these can have a significant impact on market outcomes and welfare. Throughout, agents are assumed to be able to figure out the best responses to other agents' actions, anticipate future moves, and work with stochastic outcomes.

Heijnen and Schoonbeek (2008).

[5]It took over six years of IG activism before Nike abandoned child labour (Spar and La Mure, 2003, pp. 89-91).

We have now sketched the microfoundations which are going to be used throughout this thesis: green consumer preferences, profit-maximizing firms, fully rational non-cooperative agents who are perfectly aware of the rules of the game. Yet, not much has been said about the preferences of IGs. We have simply assumed that an IG tries to minimize some harm, e.g. pollution, caused by a single firm or industry, taking into account any efforts it expends during its campaigns. To get better understanding of the incentives of IGs, one must also answer questions related to their existence: who initiates IGs and why?

As can be gathered from the above discussion, there is no scope for private politics if firms are fully aware of the green preferences of consumers or if IGs are unable to trigger or boost possible environmental considerations of consumers. Yet, even if conditions are such that private politics would yield effect, does the emergence of IGs not follow straightforwardly by appealing to standard microeconomic arguments. Individuals who contemplate initiating an IG have to be able to coordinate actions with fellow concerned citizens and ascertain themselves that not 'too many' of those concerned citizens will free-ride on their efforts. It could also be that forming an organization is redundant and that a 'grassroots' campaign suffices to bring about the desired change. We touch on these issues surrounding the existence of IGs in two chapters. In one chapter we consider private politics carried out by individual consumers. The other chapter focuses on the difficulties individuals might have to create an organization capable of lobbying a policy maker. So, that chapter focuses on private attempts at *public politics*.

Before we discuss each chapter in more detail, we briefly review some more literature.

1.1 Some Literature

Although the very first issue of the *Economic Journal* contains a (narrative) paper about boycotts (Burnett, 1891), the theoretical literature on private politics is still in its infancy. The term private politics was coined in Baron (2001). He discusses situations in which an activist (an IG in our terminology) threatens to exert effort in order to stage a boycott should a target firm not meet the activist's demands. The firm may contest the boycott or try to settle with the activist. Yet, the mechanisms that produce boycotts or thwart boycotts are 'black boxes'. It is therefore not surprising that Baron (2003), when laying out a research agenda regarding private politics, stressed among other things the need to develop theories of the motivation and behaviour of individual citizens/consumers vis-à-vis strategic activism. Feddersen and Gilligan (2001)'s analysis of a duopoly situation in which an activist supplies information to consumers does, to some extent, take into account the considerations of individual consumers. However, in their model the possibilities of the firms are rather limited: they are price-takers. Firms are able to set prices in Innes (2006), who deals with consumer boycotts. Unfortunately, the environmental organization orchestrating the boycott wields considerable, yet unspecified power over consumer preferences. Using a reduced-form model of the interactions between firms, consumers, and an IG, Baron and Diermeier (2007) investigate the selection of targets by IGs and strategies firms might employ to avoid being targeted by IGs.

The above papers provide insights regarding the behaviour and impact of IGs with *given* means to 'persuade' firms to alter their behaviour. To try to understand how and when IGs can muster sufficient power to affect firm behaviour, we draw on several literatures.

To model green consumerism we use the notion of *vertical product differentiation* (see e.g. Mussa and Rosen, 1978, Shaked and Sutton, 1982). To assess the performance of various policy instruments in the presence of green consumerism, environmental attributes of products are frequently modelled as vertical quality aspects of those products.[6] Examples include Cremer and Thisse (1999), Moraga-González and Padrón-Fumero (2002), and Bansal and Gangopadhyay (2003). Just like these authors, we consider green preferences to be exogenously given. Whether this trait stems from pure altruism, warm-glow feelings (Andreoni, 1990), or extrinsic motivations (Bénabou and Tirole, 2006) possibly caused by an endogenously determined moral ideal (Brekke et al., 2003) is beyond the scope of this thesis.[7]

Akerlof's (1970) observation that uncertainty regarding a product's quality can severely impede the performance of the associated market has spurred a vast literature on *information economics*.[8] We use several strands of this literature. We employ methods used to study problems of self-selection (i.e. *signalling*, Spence, 1973, Milgrom and Roberts, 1986) to investigate situations in which a firm does not know how concerned consumers or IGs are about its environmental misconduct. More straightforward methods suffice in case an IG can credibly communicate to consumers the true extent of the problems firms are causing. Yet, we do try to account for the fact that talk is cheap (Crawford and Sobel, 1982).

[6]See for instance Teisl et al. (2002) for evidence that some consumers have indeed green preferences.

[7]So, we do not consider the microfoundations of the microfoundations. We hope to provide microfoundations of private politics at the subatomic level in the near future.

[8]See Stiglitz (2000) for a survey of the insights provided by the first three decades of information economics.

Strategic activism initiated by individual consumers/citizens can be hampered by *collective action problems* (Olson, 1965). Individuals might have an incentive to *free-ride* on the efforts borne by others. Moreover, without the means to communicate with others, coordination failures are bound to deteriorate the efficacy of an individual's initiatives. Despite these problems, *private provision of this public good* (Bergstrom et al., 1986) might occur. To tackle the kind of collective action problems we have to deal with, we use a model which is closely related to *participation games* (Palfrey and Rosenthal, 1983, 1984). This model also features *rent-seeking contests* (Tullock, 1980).

1.2 Outline

Chapter 2 deals with an IG (specifically, an environmental group) capable of triggering or boosting consumers' (dormant) greenness. We investigate whether the presence of such an IG can affect entry decisions. The IG attempts to reduce the aggregate pollution caused by a hitherto monopolized industry. A potential entrant, which is able to employ a less polluting technology than the one used by the incumbent firm, anticipates that the IG will initiate a campaign directed at the industry's customers in the near future. Whether it is profitable for the potential entrant to enter the industry depends on the precise impact of the IG's future campaign on consumer preferences, on the relative environmental quality of the entrant's product compared to the incumbent's product, and on the relative efficiency of the entrant. The IG's future actions can thus affect current entry decisions. Since entry intensifies competition, which in turn increases aggregate sales, whether the IG's presence reduces pollution is a priori not clear. We investigate this issue, considering a broad class of possible 'campaign technologies'.

Consumer preferences are held fixed in Chapter 3. In that chapter we focus on the short-run impact an IG can have on market outcomes if it can inform consumers about the damaging aspects of firms' production practices. Since by assumption a consumer's utility decreases in the amount of damage associated with the good that consumer buys, more information regarding damage levels can enhance welfare. The IG is interested in reducing aggregate damage. If it informs consumers about damage levels, then the IG effectively creates vertical product differentiation between relatively clean products and relatively dirty products. This leads to a shift in demand towards relatively clean products. The IG, however, does not know the damage levels of individual firms in advance and has to engage in costly investigations before it can inform consumers. Moreover, firms can respond to any information provided by the IG by adjusting prices. The main question we like to answer is what kind of industries are prone to become the target of such investigations and subsequent information provision to consumers.

Competition between firms is absent in Chapter 4. In that chapter we investigate the role two-sided asymmetric information plays in strategic activism. In particular, can two-sided asymmetric information lead to impasses between an IG and a firm? The setting is as follows. An IG can inform consumers about the damaging aspects of the production practices of a monopolist firm. In contrast to the short-run situation of Chapter 3, the firm has the option to adopt a clean, yet more expensive technology. It can do so before the IG possibly initiates a costly campaign aimed at informing environmentally motivated consumers. The firm does not know how concerned the IG is about its perceived misconduct. A very concerned IG (i.e. a high *saliency* IG) expends a lot of effort during the campaign, thereby informing a lot of consumers. This leads to a substantial reduction in sales and thus in profit. Whether switching to the clean technology - a technology to which the IG does not oppose - is optimal for the firm therefore depends on the saliency of the issue as perceived by the IG. Of course, it also depends on the costs associated with the two technologies. This is private information of the firm. We study how the IG and the firm cope with the uncertainty they face.

In Chapter 5 we leave the realm of IGs. In that chapter we explain the incidence of consumer boycotts. Consumers suddenly learn that a monopolist firm does not abide by their green standards. The firm can, however, adopt a clean technology in the future. The cost of switchting to the clean technology is common knowledge. The impact of the firm's environmentally unfriendly behaviour on an individual consumer's utility and thus his demand for the firm's product is private information of that consumer. Whether it is optimal for the firm to switch thus depends on the extent of consumers' greenness. The firm does receive one signal regarding this greenness: there is one market period before the firm has to decide whether or not to adopt the clean technology. The aggregate sales during this first market period can be indicative of consumers' greenness. Consumers consequently might have an incentive to overstate their greenness by buying less than the quantity that maximizes their utility in the first market period. By doing so, consumers increase the chances that the firm adopts the clean technology. Green consumers reap the benefits from such a switch during future market periods. We coin this phenomenon, i.e. strategically reducing the quantity demanded below the quantity that maximizes one-period utility in order to increase the chances that the firm betters its behaviour, a *consumer boycott*. Whether such boycotts can occur is the main issue we like to resolve in this chapter.

In Chapter 6 we look at the formation of interest groups capable of lobbying policy makers. We try to figure out when lobbies are likely formed and to what extent they affect social welfare. These groups, simply called *lobbies*, have to be built up from scratch by individual citizens who oppose the incumbent policy maker's plans. Citizens cannot coordinate actions with like-minded fellow citizens before they have a full-fledged organization at their disposal. The formation of lobbies might thus be impeded by collective action problems. By the same token, purely wasteful lobby formation, i.e. the formation of several lobbies trying to accomplish the same policy change, might occur. The policy maker can set the rules of the game: it can convey to potential lobbyists how difficult it is to influence his decisions. Clearly, a corrupt policy maker chooses other rules than a benevolent policy maker does. We investigate the circumstances under which lobbies thrive by varying the distribution of political prefences in the population, the level of political polarization (i.e. the political distance between the various groups in society), the cost of getting organized, and the policy maker's level of benevolence. We also compare an individual's incentive to initiate a lobby with her incentive to become a candidate in elections for policy maker.

We summarize our main results in Chapter 7. That chapter also discusses limitations and avenues for future research.