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The microeconomics of strategic activism

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Chapter 7

Conclusions

7.1 Summary of Results

We have argued in Chapter 1 that the existing theoretical literature on strategic activism does not provide satisfactory, microfounded explanations for various classes of private politics. This thesis tries to fill this gap. Moreover, we have also contributed to answering the next research question. Why do interest groups emerge? Are these entities necessary for bringing about the desired change? Let us briefly discuss the main findings.

We started in Chapter 2 with an IG capable of greening consumers' preferences. A relatively clean firm anticipating such greening directed at a given industry's customers might opt to enter that industry because of the IG's presence. If this happens the IG *induces* entry by the environmentally more friendly firm. The potential entrant has higher marginal costs than the incumbent firm. This incumbent firm hitherto monopolized the market. The reason that the industry becomes more lucrative for the potential entrant is that the IG increases the degree of vertical product differentiation (consumers effectively attach more weight to the pollution aspect of the products). Since entry increases competition and thereby aggregate sales, the effect of the IG's campaign on industry pollution is a priori not clear. If the relative environmental quality of the entrant's product is sufficient to warrant entry, then *average* pollution per unit sold by the two firms goes down. Yet, if the entrant's production practices are only somewhat better than those of the incumbent, then *total* pollution associated with the aggregate sales of the two firms can go up. This perverse effect happens in particular if the IG's campaign technology is inefficient and the design of the campaign is such that it stresses the environmental differences between the products. The environment is then worse off due to the IG's presence.

In these cases the IG would prefer *ex ante* to commit to a silent strategy or redesign the nature of its campaign.

The prospects of the IG considered in Chapter 3 are better: its actions unambiguously reduce aggregate environmental damage. This IG has the option to investigate firms' practices at a cost and subsequently inform environmentally motivated consumers about its findings. Importantly, revealing differences in damage levels across firms effectively creates vertical product differentiation between those firms: less damage means higher quality. The IG's information, if any, thus affects the level of competition. It turns out that the IG becomes more inclined to carry out investigations as the number of consumers increases, the level of product heterogeneity decreases, or the number of firms increases. Note that both a decrease in the level of product heterogeneity and an increase in the number of firms bring about a decrease in the market power of an individual firm. This decrease limits the scope of the firms for mitigating the IG's impact by adjusting prices. Furthermore, the IG is keen to investigate firms if the variability of damage levels across firms is considerable. The larger this variability, the more likely it is that the IG encounters 'extreme' damage levels (either very low or very large). Revealing such extreme levels leads to a significant reduction in aggregate damage. Surprisingly, the IG's intervention not only increases expected consumers' surplus, it also increases expected industry profits. This effect stems from the vertical product differentiation the IG has created. Such differentiation relaxes price competition, leading to higher expected profits.

In contrast to the IGs encountered in Chapter 2 and Chapter 3, the IG of Chapter 4 can influence the technology choices of a firm. This IG operates in an environment in which information is scarce: consumers are unaware of the damaging aspects of the technology a monopolist firm is currently using, the IG does not know how expensive an alternative, clean technology is, and the firm does not know how concerned the IG is about its malpractice (i.e. the saliency of the issue as perceived by the IG). The IG requests the firm to adopt the clean technology, threatening to inform part of the consumer population about the firm's malpractice should the firm stick to the dirty technology. A high saliency IG separates itself from a low saliency IG by *burning money*. For instance, it pays the firm a visit accompanied by independent experts who require hefty paychecks. A low saliency IG would never do that, because for such an IG those paychecks are not worth the issue at stake. The reason to burn money is that by conveying to the firm to care a lot, the IG increases the probability that the firm adopts the clean technology: adopting the clean technology is more attractive for the firm when it preempts a large campaign than when it preempts a small campaign. Yet, such money burning does not always lead to the clean technology

and a large and costly campaign ensues. Such *impasses* occur because adopting the clean technology is prohibitively expensive (something the IG does not know) and at the same time the IG has a high saliency (something the firm does not know). Clearly, the IG's presence is detrimental for the firm's profit. Whether consumers are better off if the IG is present depends on whether or not they ever learn about the damaging practices of the firm if the IG does not inform them. If they remain unaware of the damage, even after consuming the good, then the IG never blocks trades which are later regretted by buyers. However, if consumers do learn about the damage after buying the good, then it does block such trades. The IG thus only improves consumers' well-being in the latter case.

Consumers cannot rely on an IG to improve a firm's environmental standards in Chapter 5. Consumers suddenly learn that a monopolist firm employs a damaging technology. They would like the firm to adopt an alternative, clean, yet more expensive technology. Since the firm only switches if it perceives consumers' greenness to be sufficiently high, consumers have an incentive to signal a very high level of greenness. A consumer can only do so by strategically reducing his purchases in the first market period, i.e. by engaging in a consumer boycott. In all equilibria consumers engage in boycotting if and only if they have an intermediate level of greenness. Consumers who are hardly environmentally motivated obviously do not boycott. On the other hand, strongly environmentally motivated consumers need not boycott: simply reducing purchases towards their new one-period utility-maximizing quantity associated with the lower environmental quality suffices to induce the firm to switch. For consumers with intermediate levels of greenness boycotting is essential to induce this switch. Importantly, the possibility to free-ride on the boycotting efforts borne by others does not preclude boycotting: in any equilibrium the firm does not switch as soon as one consumer does not participate in the boycott. The firm switches more often to the clean technology compared to a situation in which the firm knows consumers' level of greenness, rendering the firm worse off compared to the latter situation. Yet, because foregoing purchases in the first market period reduces boycotting consumers' utility, consumers do not gain much by boycotting.

At the start of the game considered in Chapter 6 there is no organization promoting the interests of specific groups of citizens vis-à-vis a policy maker. Each citizen has the option to set up an organization capable of lobbying this policy maker. The policy maker plans to implement the socially optimal, centrist policy. Citizens who prefer a more extreme policy, either more left-wing or more right-wing, thus have an incentive to initiate a lobby. Indeed, if setting up such a lobby is not prohibitively costly, then citizens with 'extreme' policy preferences initiate a lobby with positive

probability. This leads to an equilibrium with a random number of lobbies at each end of the political spectrum. How successful a given lobby is in the subsequent lobbying process depends on the level of political polarization, the level of benevolence of the policy maker, and whether a given lobby faces competition from a lobby with opposing interests. The stronger the polarization, the more citizens can gain by lobbying and thus the more efforts are expended in the lobbying process. This increases the probability that lobbying is successful. A purely benevolent policy maker will not be swayed by a lobby's request to implement a socially undesirable policy, no matter the amount of efforts expended by this lobby. By contrast, a corrupt policy maker lures citizens into lobbying by setting the rules of the game such that chances are that the policy maker does cater to a lobby's wishes. Lack of benevolence on the part of the policy maker thus increases the prospects of a *given* lobby. Yet, at the same time it is more likely that a lobby faces competition from a lobby at the other end of the political spectrum if the policy maker has rent-seeking motives. This competition between IGs increases lobbying efforts, but decreases the probability that the policy maker meets a particular lobby's demands.

We find that citizens who do not oppose the policy maker's plans, i.e. citizens who prefer the centrist policy, have weak incentives to counter the lobbying activities of citizens with extreme preferences. Lobbying is therefore bound to decrease social welfare. Especially the interplay between political polarization and a corrupt policy maker is detrimental to welfare: strong polarization enables a corrupt policy maker to extract considerable lobbying rents by facilitating the lobbying process in a clever way. Those who do lobby have no viable alternative to lobbying, as our comparison of the lobbying game with a *citizen-candidates* election game reveals. If the number of citizens with extreme preferences is small and the electorate is strongly polarized, then the electoral prospects of candidates with such extreme preferences are particularly dire. Lobbying then offers the only possible route to implementation of an extreme policy.

7.2 Implications

Whether an IG's intervention in a market is beneficial for social welfare depends crucially on the objectives of the IG and its choice of instruments. The IG's weapon of choice in Chapter 2 is akin to persuasive advertising: its campaign triggers/boosts consumers' greenness. This entails a change in consumers' preferences, rendering a sensible welfare analysis impossible. Yet, this chapter contains an important warning for policy makers: it is possible that an IG's actions, by affecting the market

structure, *increase* the total damage an industry causes. Subsidizing IGs as a means to indirectly reduce damage can thus be a bad idea.

The analyses of Chapter 3 and Chapter 4 suggest that an IG informing consumers about the production practices of firms alleviates market failures stemming from asymmetric information regarding those practices. However, there is caveat. We have assumed that an IG credibly and truthfully informs consumers. This can only occur if the IG has built a reputation with consumers. Building a reputation takes time and might require wasting valuable resources. Yet, even if one observes information provision by an IG with a respectable reputation, does the conclusion that welfare is being improved not follow suit: it might be optimal for IGs to occasionally lie at the expense of its reputation. So, Chapter 3 and Chapter 4 actually yield a policy recommendation in line with common legal practice: an IG should not be allowed to lie in advertisements or other instances of media coverage.

More interestingly, in Chapter 3 we concluded that an IG is inclined to target relatively competitive industries with a large number of customers and large variability in damage levels across firms. This leaves industries which do not fit this description for regulation by a public party. In Chapter 4 we emphasized that the finer details of the information structure matter when it comes to the welfare properties of an IG's market intervention. Whether the damage associated with a certain good is a credence attribute or an experience attribute of that good has a significant impact on consumers' well-being. If the damage is a credence attribute, then consumers never learn about the damage unless an IG informs them about it. One could adopt the cynical view that an IG should not inform consumers about a credence attribute of a good and just let them consume in blissful ignorance.

Chapter 5 deals with an imperfectly informed firm. Consumers can engage in boycotting to induce the firm to switch to a clean technology. Compared to a situation in which the firm is perfectly informed regarding consumers' environmental stance, the firm switches more often. So, a policy maker advocating the adoption of clean technologies can be helped by firms' uncertainty regarding consumers' greenness.

The analysis of Chapter 6 indicates that lobbying is less innocuous than perceived by scholars employing a common agency model to investigate lobbying. The argument that the policy impact of one lobby will to a large extent be offset by the policy impact of another lobby does not hold in our framework. The reason is that a policy maker has some discretion in designing the lobbying process. Those who contemplate initiating a lobby acknowledge this power and consequently condition their choice whether or not to initiate a lobby on the (lack of) benevolence of the policy maker. A more corrupt policy maker leads to more welfare-deteriorating lob-

bying. A ban on lobbying cures for this symptom of corruption and might reduce the incentives of people with rent-seeking motives to become part of a legislature.¹

7.3 Limitations and Future Research

We have only considered IGs with rather limited possibilities. It is argued that an IG can successfully resort to specific instances of private politics, but the toolbox of each IG we considered contained only one instrument. In practice though, an IG has various instruments of private politics at its disposal, frequently using multiple instruments in concert to combat the perceived malpractice of firms. A model that allows an IG to choose a mix of instruments would certainly be a welcome addition to the literature.

Our analyses are not only partial because the markets under consideration operate in isolation, but also because the IGs we encountered operate in relative isolation. Except for the public politics situation of Chapter 6, no IG faced competition from opposing IGs or had difficulties financing its projects. The *industrial organization* of IGs engaging in private politics is thus left out of the picture. We have only dealt with the interactions between one IG, consumers, and firms. Yet, understanding the interactions between various IGs (and their ramifications with regard to the interactions we investigated) might be just as important to understand strategic activism.

Allowing for multiple IGs will also bring to light the need to pay closer attention to IGs' objectives. We have assumed throughout that IGs play the rather benign role of law-abiding entities which are solely concerned with reducing the harm caused by firms. However, some instances of private politics might create scope for *rent-seeking* behaviour. In fact, one could envision that the possibility to appropriate such rents in the future is a motive to erect an IG in the first place. Rent-seeking motives might also create a wedge between the objectives of members/donors of an IG and those who run the IG on a daily basis. Such principal-agent problems might crucially affect the strategies of IGs.

We have looked at IGs in rather *static* environments. Occasionally, we have hinted at the dynamic component of private politics. For instance, when we considered impasses in Chapter 4. That analysis is, however, somewhat unsatisfactory because the framework we used lacks full-fledged dynamics. However, IGs have to build a *reputation* before their complaints regarding firms' misconduct resonate with consumers. A dynamic framework is needed to explain how an IG builds up a reputation and

¹We are aware of the adage "power corrupts". This policy recommendation only deals with exogenously given rent-seeking motives.

manages an existing reputation. Lastly, a dynamic framework might reveal that an IG targets firms or industries in a specific order or that an IG adjusts other aspects of its strategy (choice of instrument, the nature of the requests it makes to firms) over time.

Finally, the downside of our focus on microfoundations is that the models we develop have not much empirical bite and thus lack predictive power. We argue that strategic activism does occur under certain conditions, but methods to assess whether such conditions are met in a particular situation are beyond the scope of this thesis.² On a more fundamental level and as is often the case with exercises in economic theory, procedures with which one can try to falsify (aspects of) the theories presented are also absent.³ We hope that, despite these shortcomings, our ‘fables’ still provide valuable insights.

²Observe that predicting strategic activism could trigger it in some cases: the prediction unveils the informational asymmetry thereby causing the predicted activism. This effect reduces the prediction to a self-fulfilling prophecy.

³See Rubinstein (2006) for an interesting discussion of the (lack of) relevance of such purely theoretical exercises which dodge the Popperian maxims.

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