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Review

Watchdogs of the Invisible Hand: NGO monitoring and industry equilibrium☆

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ABSTRACT

Globalization has been accompanied by rising pressure from advocacy non-governmental organizations (NGOs) on multinational firms to act in socially-responsible manner. We analyze how NGO pressure interacts with industry structure, using a simple model of NGO-firm interaction embedded in an industry environment with endogenous markups and entry. We explain three key empirical patterns in developing-country industries under activist pressure: the degree of exit under more intense activist pressure, the differential response of industries to NGO activism, and the general rise of NGO activism following globalization.

1. Introduction

Rise of private regulation of firms by non-profit activists is an important recent phenomenon. Such regulation normally arises in settings where the government is easily influenced or captured by firms (Baron, 2010, Chapter 4). Alternatively, private monitoring and regulation emerges when standard labor and environmental regulations and governmental enforcement systems on which they depend are overwhelmed by rapid changes in the economy (O'Rourke, 2003). One key example is the environment in which multinational enterprises (MNEs) in developing countries operate. These firms are often pressured by non-governmental organizations (NGOs) whose declared objective is reducing the negative effects of globalization. NGOs engage in "private politics" (Baron, 2001), i.e. exert pressure on multinational firms and exploiting their campaigning capacity, so as to induce the firms to adopt socially responsible practices. The well-known examples of such NGO activities include the international campaigns against Nike (triggered by the poor working conditions in its suppliers' factories in Vietnam), WalMart (caused by its' anti-union activities), and Tiffany & Co. (related to the sales of 'conflict' diamonds). The techniques employed by NGOs vary from lawsuits and organized political lobbying to mobilizing consumer protests and boycotts to destruction of firm property.[1]

The economic analyses of the interaction between NGOs and corporations have so far concentrated on one-to-one (i.e. one NGO, one firm) interactions or models with a fixed market structure, usually a simple oligopoly (Baron, 2001, 2003; Baron and Diermeier, 2007; Bottega and DeFreitas, 2009; Feddersen and Gilligan, 2001; Immordino, 2008; Krautheim and Verdier, 2012). To the best of our knowledge, there exist neither any analyses of the effects of NGO pressure on long-run industry-level economic outcomes (i.e. long-run aggregate output, market structure, entry and exit into the industry, intensity of competition,

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[1] Yaziji and Doh (2009) and Baron (2010) provide excellent descriptive analyses of the interactions between NGOs and multinational firms.

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and share of firms engaging in socially-responsible behavior), nor any studies that conversely address the effect of industry-level changes on the intensity of NGO activism.[2]

Conducting a fully-fledged theoretical analysis of the effects of NGO activity on an industry as a whole (rather than on single firms or a fixed market structure) is important for several key reasons. First, a host of industry-level variables that are crucial for economic behavior simply cannot be studied in single-firm models. These include, for instance, the number of firms in the industry and the degree of intensity of competition between firms. Second, industry-level characteristics might, in their turn, affect the individual firms' payoffs from adopting (or not) socially-responsible actions under the pressure by NGOs, as well as the NGOs' payoffs from putting the pressure on firms. In such a case, the industry-level analysis might help to explain empirically the extent of socially-responsible actions by firms and watchdog activities of NGOs by linking them to observable industry-level variables (e.g., market size, entry costs, or the degree of homogeneity of the industry products). Finally, given that NGO pressure affects profits of individual firms and in the long run firms decide on entry to and exit from the industry, the long-run effects of NGO pressure on corporations may be quite different from the short-run effects (with a fixed market structure).

In this paper, we attempt to close this gap, by analyzing the industry-level short- and long-run equilibrium effects of NGO pressure. To do so, we build a game-theoretic model of the interaction between an NGO and firms, in which the NGO monitors the adoption by firms of 'socially responsible' actions, and the firms decide between taking the costly socially-responsible action or eschewing this action and facing the risk of a damage inflicted by the NGO if the non-adoption is discovered. We then embed this interaction in a model of monopolistic competition with heterogeneous firms and endogenous mark-ups (Melitz and Ottaviano, 2008; Ottaviano et al., 2002). Conveniently, this model allows us to capture, in the short run, the interaction between the degree of competition in the industry (i.e. endogenous price margins), the monitoring effort by the NGO, and the fraction of firms adopting the socially responsible actions. Allowing for free entry, we then determine the long-run equilibrium market structure (i.e. the number of firms in the industry), together with the three variables mentioned above. We study how the short- and long-run industry equilibria change in response to exogenous changes in NGO payoffs, firm technology (production costs), and consumer preferences.

Our main contribution is to build a unified model that describes, on the one hand, the effect of NGO monitoring on industry structure and equilibrium, and, on the other hand, the impact of changes at the level of industry (such as, for instance, an increase in market size or a change in consumer tastes) on the intensity of NGO activism. In other words, we analyze both how the "watchdog" affects the workings of the "invisible hand" (the industry competition), as well as how the workings of the "invisible hand" (globalization) affects the behavior of the "watchdogs". Our model's predictions (about the degree of monitoring of firms by NGOs, the decisions of firms of adopting socially responsible actions, the intensity of competition in the market, and, in the long run, the number of firms in the industry) is able to explain three key empirical patterns of developing-country industries under NGO activism, that we describe below.

In addition, our analysis helps to clarify the debate about the role of competition in inducing unethical behavior (see Shleifer, 2004 for an informal discussion and examples, and Cai and Liu, 2009 and Fernandez-Kranz and Santalo, 2010 for empirical analyses). We show that when ethical behavior by firms is monitored by NGOs, the intensity of competition and the extent of ethical behavior are jointly determined. The direction of the empirical correlation between these two measures crucially depends on the *origin* of exogenous changes that induce the variation in both. For instance, a change in consumer tastes can lead to more intense competition and less socially-responsible behavior, whereas more generous financing of watchdog NGOs induces more intense competition between firms and more socially-responsible behavior.

1.1. Key patterns in developing-country industries under NGO pressure

Three interesting patterns have been documented by observers about the industries under NGO pressure in developing countries. The first is that although the NGO pressure seems to affect the individual firms' behavior in the short run, rising NGO activism seems to lead firms quitting the industry in the long run. In a seminal empirical analysis of the textile, footwear and apparel industries (TFA) in Indonesia, Harrison and Scorse (2010) show for instance that in the districts with more intense NGO activism, the probability of plant shutdown (in particular, for smaller firms) in the TFA sector is significantly higher than in districts with less intense activism (see their Tables 8A and 8B). The authors find that this is driven by large fall in profits emanating from the NGO pressure. They also argue that this exit might result in a re-location of the economic activity in the TFA sector into other low-wage countries.

The second pattern comes from comparing different industries under the NGO pressure. Giuliani and Macchi (2014) and Giuliani (2014) describe differences in multinationals' respect of human rights and separate the industries into "window-dressing" (i.e. those in which firms pretend to respect the ethical standards but in reality do not) and "rights-oriented" ones (in which multinationals truly follow the standards). They also stress the key role played by the NGOs, but note that "the level of industry competition and the lifecycle stage of the industry also play a role… Thus, industry specificities might also condition the human rights conduct of cluster firms" (Giuliani, 2014: 9). For instance, the reports by the Environmental Justice Foundation (2013, 2014) and Accenture Development Partnerships (2013) suggest that although the seafood production industry is a sector economically comparable to the garment industry (e.g. it is the second-largest after ready-made garment industry in Bangladesh), the responsiveness of the two sectors to activist pressure to eliminate exploitative labor practices seems to be very different. In particular, NGOs' numerous attempts to enforce the codes of conduct and certification schemes in the seafood industry in Bangladesh and Thailand failed (whereas the garment industry seems to be much more responsive; see, for instance, Baron, 2010: 112-115). Diamond industry is another example of a strong responsiveness of multinational firms to the NGO pressure to stop sourcing from conflict-ridden countries and to change the production technologies towards more environmentally-friendly ones (see Bieri, 2010; Yaziji and Doh, 2009: 162-165). Contrarily, the palm oil industry seems to implement de facto very little change in practices, and essentially rely on "greenwashing" techniques, despite the activist pressure (see, for instance, Rainforest Action Network, 2011).

Finally, the third pattern concerns the broader behavior in NGO activism in the long run. Over the last two decades, there is some indication of the rising importance of NGO activism for the corporate world. For instance, there has been a twenty-fold increase in the number of citations referring to NGOs in *Financial Times* over the last ten years (Yaziji and Doh, 2009). Harrison and Scorse (2010) also note that the number of articles regarding child labor - one of

[2] The only paper that studies the industry-level effects of corporate social responsibility is Besley and Ghatak (2007); however, in their model, NGOs are modelled as direct producers, rather than private monitors or advocacy organizations, as in our model. Examples of other models in which NGOs act as producers of goods and services in developing countries and compete with each other are Aldashev and Verdier (2009, 2010) and Guha and Roy Chowdhury (2013).