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**Discussing Industry Self-Regulation: The Contribution of a  
Transactional and Institutional Perspective**

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## Discussing Industry Self-Regulation: The Contribution of a Transactional and Institutional Perspective <sup>1</sup>

### Introduction

In view of the growing concern about business scandals related to human rights issues, environmental degradation, corruption, fraud, and other dysfunctional behavior, society seeks institutional solutions for mitigating those actions and the perceived externalities they create for social welfare. Among the set of possible solutions, industry self-regulation has received a prominent status, both in theory and practice. It stands to reason that in order to develop an informed understanding about the possibilities and limits of this instrument and its ability to institutionalize a socially desired behavior and associated ethical values has to be discussed. Through this paper, I attempt to provide a contribution to this discussion by highlighting the limits of formal mechanisms and the role of incentives for contributing to self-regulation rules.

By definition, the distinct reason of self-regulation is to mitigate arbitrariness in actions. It ought to make a certain socially desired behavior a regularity, in the sense that society can expect that within an industry respect for ethical values is not random and arbitrary (which in the worst case would mean non-existent) but instead *institutionalized*. The dilemma of self-regulation, however, is that it inevitably develops against the background of a trade-off between morals (ethical standards) and profit. Of course, there are situations conceivable in which adherence to ethical standards reflects positively on the bottom line – in a monetary measurable sense. For example, cases where price premiums can be realized because consumers choose organic or sweatshop free products do exist. They should not be confused, however, with industry self-regulation, because in these cases, *market incentives* dictate that following ethical standards is profitable. Although certainly a desirable and sometimes feasible alternative for the institutionalization of ethical standards, the actual problem I intend to investigate is not relevant in these cases. Where market forces reward ethical behavior, the problem of social cost fades and regulative intervention is obsolete. This is why self-regulation is here understood as an act of *voluntarily constraining* options for profit making, by committing oneself *credibly* to certain norms and values. Collective action in the form of self-regulation ought to make commitments to ethical standards credible, in that the self-regulating firm communicates “I belong to this network of firms and we have mechanisms in place that ensure that I stay committed to respect ethical values in my operations, even if this means that I forgo on (short-term) options for making profit.”

However, such self-regulation has an immanent dilemma: In the face of unethical practices being profitable, would the profit-seeker be motivated to voluntarily abandon the opportunity to make a profit by installing mechanisms (i.e. a self-regulation regime) which assure that these opportunities are no longer available, in order to secure socially acceptable conduct? As profit generation is the one original purpose of the firm, it remains to be explained why a firm would then at all self-regulate in an effective way. More specific, it must be explained why a firm would voluntarily (that is, without direct outside enforcement) contribute to

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<sup>1</sup> Some of the ideas proposed in this paper are based on Sammeck (2011, forthcoming).

mechanisms that force it to internalize social costs, as the firm then not only incurs opportunity cost in the form of missed deals, but also real cost in the form of contributions to a self-regulation regime, which monitors and enforces the desired standards of behavior. In other words, what drives the firm towards making a credible commitment to ethical standards?

### **Motivating Commitments to Ethical Conduct**

I approach the above question based on a few simple premises: The firm is interpreted as a corporate actor<sup>2</sup>, and consequently understand it as an individual entity. Drawing on the theory of the new institutional economics, the behavioral characteristics that can be ascribed to the firm<sup>3</sup> are bounded rationality, striving to maximize monetary utility (or profit), and opportunistic behavior where it is in its interest to do so.

Given these premises, it remains to be shown why a firm would engage in efforts of self-regulation, given that these are costly and restrain options for profit-making.

To approach this matter, I first turn to the term commitment; specifically understood as being committed to respect and follow certain ethical norms and values in one's actions. I differentiate this term further into *individual* and *collective* commitment. The main difference between the two is that in the first a firm can generally be thought to commit itself to a certain path of action, where the decision to do so is made *independent* from considerations about what peers do, whereas in the latter, the decision to commit itself to a certain path of action is made *depending* upon whether peers agree to do *likewise*. In the latter case, firms then give a *collective commitment*. In either case, a commitment is credible when possibilities to follow certain other actions (that violate the ethical standards) are ruled out from the set of feasible actions and certain options for profit making become infeasible for the firm.

The traditional answer found in theory on self-regulation to the question of why a firm would engage in a commitment to voluntarily constrain options for profit making is that it wants to maintain *legitimacy*. Legitimacy can be defined according to Suchman (1995, p574) as "(...) the generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions." Consequently, if a firm's actions are to be considered legitimate, they require compliance with those norms and ethical values of society that are translated into expectations towards it (compare Suchman 1995). In order to become legitimate, an organization thus has to fulfill these expectations (compare Dowling and Pfeffer 1975; Meyer and Rowan 1991). As legitimacy is earned through compliance with expectations about what is the right conduct, it can be withdrawn or denied in the case of non-compliance. In that case, a corporate actor is vulnerable to claims that it is negligent, irrational, unnecessary, obsolete, or even harmful.<sup>4</sup>

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<sup>2</sup> We take this definition from Coleman (1990).

<sup>3</sup> For an overview of these premises, see Richter and Furubotn (2003 p3ff).

<sup>4</sup> Maintaining legitimacy will ultimately demand that the organization acts according to normative demands of societal stakeholders. This means, a company has to adopt actions which are socially desirable, in order to persuade stakeholders towards a positive evaluation of its actions, and thus enhance its survival chances. Compare in this regard Scott (1991, p169); Clarkson (1995); Freeman (1984).

From this argumentation it follows that self-regulation relates to legitimacy in the following way:

The act of self-regulation is defined as the ensuring of socially desirable behavior among a group of firms. It hence serves as a means to guarantee conformity of corporations' actions with societal norms, and consequently helps them to secure legitimacy.

The nature of this interplay between society (or more precisely: stakeholders) and a firm is transactional. A transaction can be described as an action which is "taken in which an entity, such as a commodity, social attitude, emotion, opinion, or information, is transferred from one social unit to another, where social units can be individuals, organizations, or other entities." (Greif 2006, p46).

Within that framework, legitimacy can be defined as an object of exchange which is transferred from stakeholders to the firm. Given the assumption of the profit maximizing firm, however, legitimacy must serve some profit-making purpose, such that this transfer is of value. This 'value' of legitimacy can be defined using transaction cost theory:

Theory of transaction cost recognizes that while executing a transaction, a firm encounters (external) transaction costs (compare Coase 1960; Williamson 1985; Williamson 1996), because transactions seldom function frictionless but instead incur costs related to misunderstandings, conflicts, breakdowns, and other malfunction (Williamson 1981, p525). That is, the costs that an individual in an exchange experiences because it has to solve conflicts with the opposing party – via negotiation, bargaining, monitoring, sanctioning, rewarding, or otherwise influencing the incentives & strategies of the opponent – are transaction costs. Transaction costs relate to legitimacy in the following way:

Particular stakeholders engage in transactions with a firm in that they exchange specific resources with the firm, such as goods, money, labor, or security of property rights. These transactions are subject to ethical norms: a violation of norms throughout the production and selling processes of the firm may weigh negatively on some societal stakeholders' welfare. When this is the case, legitimacy may be withdrawn which consequently decreases the options for future actions of the firm and its ability to access the resources exchanged in stakeholder transactions. The transaction 'legitimacy' is thus connected to other economic and political transactions and influences the costs at which these take place. A loss of legitimacy may thus increase the costs of transacting; for the affected firm it may consequently become expensive to produce and sell – in some cases even prohibitively so – when violating certain moral demands and standards. In its effort to maximize profit, the firm must try to mitigate such transaction costs or avoid them altogether. However, as acquiring and maintaining legitimacy incurs costs, the maximizing firm must compare the transaction costs related to a loss (or the absence) of legitimacy with the costs of acquiring and maintaining it.

The above reasoning describes the motivation for *individual commitment*. For a collective commitment, the argument must be that a firm's legitimacy may depend on the actions of its peers and that it hence requires their cooperation in order to secure it.<sup>5</sup> This is the case when

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<sup>5</sup> Generally, a collective commitment will be given whenever (1) this eliminates some of the external costs that the private actions of other firms cause for the firm in question, or (2) when it is required to secure a benefit that the firm cannot possibly secure through private action (Buchanan and Tullock 1965, p41-44).

either (1) reputational spill-over effects require firms to collectively comply with ethical standards in order to avoid transaction costs on an industry wide level, or (2) competitive rivalry demands that ethical standards are collectively followed, because individual action seems more costly. In the first case, reputations of firms may be immovably connected with each other, thus creating an industry reputation commons. Here, individual commitments may be ineffective for managing industry legitimacy (unless, of course, all relevant firms in the industry make such an individual commitment). In the second case, the feasibility of private action is undermined by competitive disadvantages incurred by those who make an individual commitment. For example, when conditions of competition force the firm to operate on small margins, because of, e.g. highly price-sensitive customers, the internalization of costs associated with ethical standards can lead to a competitive disadvantage which would eventually drive it out of the market. By forming an industry-wide commitment, actors seek to make these costs competition-neutral, thus mitigating the impact that costs of compliance with ethical standards have on the maximization of profit, while still securing a reduction of transaction costs in stakeholder transactions.

It follows, that *effective* collective commitment demands that firms *cooperate* with each other. Cooperation, however, between maximizing and potentially opportunistic actors is difficult to achieve, because the individual firm may create an advantage for itself if it behaves opportunistically. This circumstance manifests in a prisoner's dilemma, in that there is conflict between the mutual interest to avoid costs incurred in transactions with relevant stakeholders, and the conflictive incentive to not contribute to avoiding these costs in order to maximize own profit.

### **An Economic Approach to Industry Self-regulation**

The prevalent solution to overcoming such a dilemma is to make commitments credible by using appropriate mechanisms, specifically monitoring and sanctioning. For a collective commitment to ethical norms to become credible, the firms would hence have to create a self-regulation regime which actually enforces the adherence to ethical standards among them by providing such mechanisms. Then, not reneging from one's commitment becomes the maximizing strategy and firms will be motivated to honor ethical values, simply because it is in their best interest. Such a self-enforcing institution, however, is by definition the result of strategic interaction between self-interested individuals (see Aoki 2001, Bates et al. 1998, and Greif 2006), which can also be modeled as a social dilemma (Bates 1988; Heckathorn 1989). These *second-order dilemmas* are any situations whose structure makes the creation and maintenance of institutions, and the associated monitoring and incentive setting, difficult or even impossible.

I distinguish two types of situations in which the provision of an institution is not achieved, the first one being a coordination problem, while the second being one of contribution.

*Ad(1)*

Two actors are deciding about the design of an institution, where two different sets of rules (i.e. mechanisms of monitoring and sanctioning) are possible. If each insists on his own most preferred alternative, they risk getting their least preferred result.<sup>6</sup>

*Ad(2)*

In a second case, this coordination problem has been successfully solved; however, as the supply of functional institutions incurs costs, incentives to free-ride would undermine incentives to organize a solution to the collective dilemma, as actors can potentially enjoy the fruits of rules and norms without internalizing the costs of maintenance. This again represents a prisoner's dilemma.

Theory provides solutions to these problems by introducing ideas on bargaining, negotiation, signalling, authority, culture, dependency relations, or collective decision making organizations.<sup>7</sup> That is, there exist mechanisms that enable cooperation for the supply of an institution. However, this line of reasoning is not able to provide inferences about *what type* of self-regulation arrangement will be provided *under what conditions*. In particular, it is the question of whether the institution (or self-regulation regime for that matter) is able to effectively make a collective commitment credible in the sense that the socially desired behavior is actually the regularity among relevant actors. If mechanisms are too weak to set incentives for compliance, the self-regulation regime cannot contribute to institutionalizing a socially desired behavior and at best remains at the stage of 'communicated intent'.

The underlying question must thus be what the incentives for an individual firm to contribute to an *effective* set of rules are. As perceived costs and benefits are fundamental here, one must determine the factors that influence (1) what is to be gained from self-regulation and (2) what it costs to self-regulate. In other words, it is the comparison of alternative arrangements which drive the *incentive for rules* (and adherence to them) in a given industry.

To provide an explanation for the conditions under which a group of firms will devise a functioning self-regulation regime, that is, to determine the incentives for rules, I refer to fundamental ideas in the theory on transactions and public goods: (1) problems of measurement, (2) problems of interdependence, and (3) costs of supply.<sup>8</sup>

*Ad(1)*

By problems of measurement, I refer to the technical limitations in measuring the costs and in particular the benefits related to a contribution to self-regulation. Measurement problems may curtail incentives to contribute to a particular self-regulation regime in the following way: Whenever benefits of a particular transaction cannot be determined with accuracy, the valuation of the transaction may be subject to over- or underestimation. Scenarios of over- or underestimation may curtail the incentive to engage in self-regulation. In particular, to derive

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<sup>6</sup> See Bates (1988, p394-395).

<sup>7</sup> Compare for example Greif (2006, p354).

<sup>8</sup> For a detailed derivation of these attributes, see Sammeck (2011, forthcoming)



an estimate about the net benefit of self-regulation rules, a firm must have information about the following:

An estimate of the value of the received benefit (i.e. avoided transaction costs) that flows from self-regulation,

an estimate of the costs of resources that are required to secure the received benefit,

an appropriate discount rate, that is, it must anticipate what the value of self-regulation will be in the future.

The severity of the measurement problem is determined by the number of conceivable states that these may be in. A high variability in the valuation of benefits and costs increase complexity of the 'transaction' self-regulation, and thus measurement problems for determining accurate values (i.e. future value and discount rate) increase. The incentive to cooperate and contribute to rules may be weakened due to a misestimation of present value.

#### *Ad(2)*

Interdependence prevails whenever the contribution of a particular firm to the self-regulation regime is non-substitutable. When this is the case, incentives to contribute may either be supported or curtailed, depending on the variability of valuations that different firms attribute to certain possible sets of rules.

It is conducive if – among a critical group of firms that is required to self-regulate in order to convince stakeholders that the industry's commitment is credible<sup>9</sup> – a shared understanding for a net benefit of self-regulation exists and each firm understands that without its contribution to a particular (effective) set of rules, the desired benefit will not be secured.

However, interdependence can also be detrimental to self-regulation in that it may keep effective rules from being installed because of diverging valuations for rules in a critical group. Individual bargaining power for those with the least interest in an effective set of rules may lead to least-common-denominator rules (which are then ineffective) or even to no rules being supplied at all.

#### *Ad(3)*

The costs of establishing and running a self-regulation regime can be described as the value of resources that have to be deployed in order to formulate prescriptions for behavior and ensure that these are followed.

When one compares the supply of self-regulation with the production of a good, costs can be differentiated according to transformation and transaction costs.<sup>10</sup> Transformation costs are incurred whenever the firm has to adapt (transform) some of its internal organizational processes in order to achieve compliance with the regime's prescriptions. Transaction costs relate to the value of resources that are used in the processes of coordinating on a set of rules, monitoring the regime members' behavior, and sanctioning negative deviations from the prescribed behavior. Accordingly, transaction costs can be distinguished into to coordination, monitoring, and sanctioning costs.

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<sup>9</sup> I draw on Olson's (1965) concept of exclusive groups and Hardin's (1982) explanation of a step good for defining the term 'critical group'.

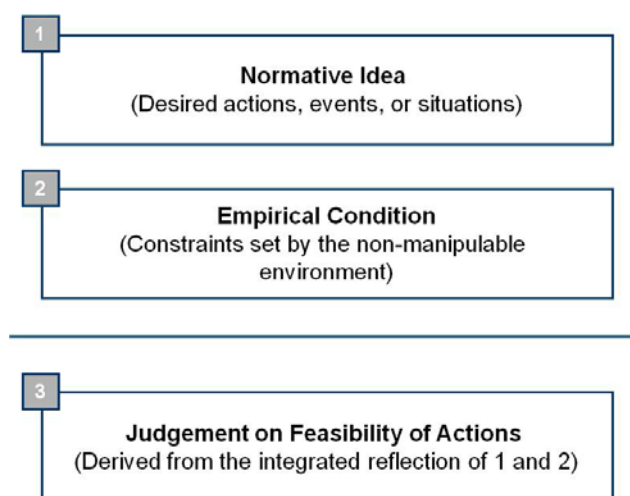
<sup>10</sup> The differentiation between transformation and transaction costs is taken from North (1990).



These categories allow for structuring institutional environments, so that one can identify the incentives that the profit maximizing company has to contribute to a set of rules from which one can expect that they institutionalize a socially desired behavior.

To illustrate how these categories relate to incentives for contributing to rules, I briefly instance the Metals and Mining Industry. The method by which I structure this inquiry draws on the heuristic of the practical syllogism (Suchanek 2007): Is that which is wanted (self-regulation) truly feasible under the given conditions (institutional industry structure)? The idea is to derive judgements about actions from the careful alignment of that which is desirable with that which seems technically feasible.

By structuring the inquiry in this way, I attempt to derive a judgement about the likely effect of self-regulation arrangements in that industry.



The aforementioned categories – measurement problems, interdependence, and costs of supply – provide the grid with which empirical conditions are observed and consequent incentives that constrain or enable effective self-regulation are identified.

### **An Exemplary Case: Self-Regulation and the Mining Industry**

The global mining industry has had a global tradition of what can be called “corporate malfeasance”, sometimes creating severe harmful consequences for the communities and the environment that surround mining site operations. Among the allegations that are related to social realms – made by public agencies, NGOs, or communities – are primarily human rights violations (Jenkins 2004), such as harm to local and indigenous populations, forced labor, worker health and safety, but also bribery and corruption.<sup>11</sup> With regard to environmental issues, extracting commodities poses dangers such as post abandonment risks, land left after mine closure, waste management (see for example, Hilson & Murck 2000), or water contamination in the extractive and post-closure phases of mines (Amezaga et al. 2011).

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<sup>11</sup> For a brief overview of sources on these problems, see Sethi & Emelianova (2006, p227) and Sethi (2005, p56).

Over time, a variety of incidents related to the above mentioned issues led to the mining industry now being under scrutiny from NGOs and media,<sup>12</sup> who try to expose bad acts of the industry.

Given the recent upswing in relevance that subjects such as sustainability, corporate social responsibility, and human rights have experienced, condoning public stir could – as is sometimes argued – seriously threaten the industry’s license to operate (i.e. legitimacy), and hamper the future operations of many firms in the mining industry (compare for example Humphreys 2001). Hence, the case can be made that the mining industry has a significant incentive to improve its reputation among relevant stakeholders.<sup>13</sup> As many firms in the industry are confronted with accusations establishing a common set of rules and standards that would level the playing field among firms should help to avoid future violations of stakeholders’ social and environmental norms and safeguard the industry’s reputation.

At first glance, the industry can thus be said to have a potential interest in self-regulation. The question remains, however, what type of self-regulation regime that would be and whether a firm in that industry has sufficient incentives to contribute to the *institutionalization* of a certain behavior.

To identify these incentives, I investigate (1) the degree to which benefits and costs associated with self-regulation are measurable, (2) whether firms in the industry really have to cooperate in order to safeguard reputation and manage stakeholder transaction costs, and (3) what the relative costs of a firm are if it commits itself to certain standards in its operation through a collective self-regulation arrangement.

#### *Problems of Measurement*

The relation between measuring the benefits and costs of a transaction and the incentive to engage in it is denoted by problems of estimation accuracy. That is, when an individual is not able to accurately determine what he can gain from a particular transaction, and what it costs to engage in it, the incentive to transact may diminish, because of an underestimation of benefits, or overestimation of costs, respectively.

Hence, it is a question of how large the variability of possible values for costs and benefits of self-regulation in the mining industry is, and in particular, the relative accuracy with which costs and benefits can be determined.

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<sup>12</sup> For an abundance of accusations and cases against the mining industry, in particular large players such as BHP Billiton, Rio Tinto, or Vedanta, see exemplarily the London Mining Network <http://londonminingnetwork.org>.

<sup>13</sup> The typical relevant stakeholders in the mining industry are governments and public agencies, international organizations such as the EU but also NGOs, communities around mining sites, labor, (compare Young 2005, p35), and of course customers and providers of financing.

For determining the benefits, I turn to transaction costs in stakeholder transactions that are mitigated if a firm can credibly commit itself to demanded standards of behavior. If one looks at the relevant stakeholders of the mining industry with regard to their influence on transaction costs, there are in particular two types of transactions which are of utmost importance for an individual company: (1) Granting of access rights by governmental and regional agencies and (2) the provision of capital by banks and other financial institutions.<sup>14</sup>

#### *Ad(1)*

For example, when governmental agencies are in favor of a certain company, this enables the company to reduce costs through limited government and planning approvals, possibly increased community acceptance, and preferred access to prospective areas and projects (compare Gunningham & Sinclair 2001). By contrast, if trust in the mining company is low – due to, for example, experience with past environmental and social behavior of the firm – governmental agencies may adopt more aggressive and conflict-laden strategies (including legal action) “in order to stop a mine or to win significant concessions in the way a mine is implemented” (Hutchins et al. 2007, p28).

#### *Ad(2)*

For a financial institution, the reputation of a company it invests in may become relevant when “unethical” actions of this corporation penetrate the bank’s own reputation, thus adversely affecting own stakeholder transactions.<sup>15</sup> Acquisition of funding to finance the extremely capital-intensive mining projects may thus become more costly for a company that has a reputation for violating ethical standards.

Concluding, the structure of these transactions allows putting an estimated value on the worth of self-regulation that is to some degree quantifiable in monetary terms, thus mitigating measurement problems.

The same is true for the cost side. Here, commitment to ethical standards often demands an adjustment of production processes, whose additional costs can be determined quite accurate.<sup>16</sup>

Furthermore, firms in the mining industry operate with comparatively long time horizons. For example, the typical exploration to production schedule maintains a 10 year average. From discovery and delineation, over evaluation, pre-feasibility, full feasibility and approvals to construction<sup>17</sup>, until the point where cash flows are generated, the mining firm has to make substantial investments. Given this timeframe, one would suspect that a firm has a particular interest in maintaining good (that is, transaction cost efficient) relations with the license providers and the suppliers of capital. This circumstance may thus unfold an additional positive effect on incentives for rules, because self-regulation rules would help to secure the

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<sup>14</sup> See in this regard also Humphreys (2001). We do not include the transactions with customers at this point, because the mining industry does not supply to end-consumers, but to other companies who then refine the commodity products into inputs for consumer-product companies. We interpret this lack of end-consumer closeness as the absence of typical brand-name safeguarding incentives.

<sup>15</sup> For an example, see <http://www.banktrack.org>, an organization comprised of NGOs that reports on bank involvement in the alleged financing of unethical business practices, primarily in sectors such as mining, nuclear energy, oil, or defence and arms.

<sup>16</sup> See in this regard also the section on transformation costs, pp15.

<sup>17</sup> Bernstein Global Wealth Mangement (2010)

necessary stability of transaction costs, given the timeframe from initial investment to generation of cash flows.

However, although it can be stated that in principle, the industry provides favorable conditions to measure the benefit of self-regulation there are some obstacles that influence the overall value of adhering to certain moral standards, and contributing to rules that ensure this adherence. Along the lines of the defined transactions with (1) the government and (2) the financial industry, the problem of measurement must be further refined:

*Ad(1)*

Many of the social and environmental catastrophes related to mining activities occur in third-world or emerging nations. Here, governmental concern with the potential consequences of mining activities is not as developed as in, for example, the EU or Canada. On the one hand, this reflects in existing legislation and handling of the industry, as for example, lack of clear policies to support waste minimization, incomplete regulatory frameworks and uneven enforcement, ignorance of the characteristics of industrial production processes, no clear understanding of the difference between compliance investments and cleaner technologies, or inefficient coordination among different governmental agencies (de Nava 1996).<sup>18</sup> However, the incentive for governments to improve on those issues in the future is often weighted against the social benefits that are secured *because* of the less restrictive regulation. For example, local populations often view a mine as an economic boost, as it provides jobs and helps to avoid poverty. Communities and populace may be less concerned with, e.g. potentially polluting activities, so long as they can earn a decent wage (Young 2005, p34). As developing economies in particular rely on their natural resources as a major source of national income, they may be less willing to engage in costly means that increase transaction costs for mining companies.

However, such cases are not only limited to developing countries. The threat of governmental intervention is sometimes also doubtful in more developed countries. For example, Amegaza et al (2011) state the following:

“In the EU, mining was exempted from the integrated pollution control measures which require all other industries to take steps at the end of production to avoid any pollution risk and return the former industrial site to a satisfactory condition”, due to lobbying activities of the industry. They further argue that “given this, it is not surprising that a string of environmental incidents were to finally expose the utter inadequacy of generic European legislation when dealing with the particular issues raised by mining. Two major tailings dam failures, at Aznalco’llar (Spain, 1998) and Baia Mare (Romania, 2000), prompted the EU to establish a Task Force, which recommended a string of legislative changes. (...) Industry lobbying weakened many of the most significant provisions originally envisaged for the Directive, such as requiring a secondary containment bund around large tailings dams. The October 2010 outburst of red mud from a tailings impoundment at Ajka in Hungary graphically illustrates how ill-advised this omission was. More broadly, the Directive did not remove the exemption of mining sites from pollution prevention legislation, and also failed to

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<sup>18</sup> For example, Hilson (2000) argues that “poorly developed environmental mandates, along with low levels of community environmental awareness gives mines little incentive to implement cleaner technologies (...) in developing countries.”

address ongoing water pollution from abandoned mine sites, which remains by far the most pressing mining environmental issue in Europe today.”

Although not necessarily exemplary for treatment of the mining sector in all EU-countries,<sup>19</sup> this case highlights a relevant issue with regard to transaction costs in governmental relations: Where governmental standards may not reflect the standards (and interests) of other groups, such as the populace of mining areas, violation of ethical standards may occur without consequences on the transaction cost side. Where governments do not actually consider the threat of legislation as an option, measuring quantifiable benefits of self-regulation is complicated.

#### *Ad(2)*

The *tendency* of banks and other financial institutions to withdraw capital from mining companies that are involved in ethically questionable projects is difficult to determine. There is no clear policy recognizable in the banking sector as to unconditionally deny capital to a firm, if that firm is guilty of proven incidents of misconduct and irresponsible behavior. The case of Vedanta serves as an example, where after several incidents of human rights violations by the London-based mining company, investors such as the Norwegian Pension Fund or the Dutch Pension Administrator PGGM opted out of their investment in the company, in 2007 and 2010, respectively.<sup>20</sup> The consequences of this in terms of real cost, however, are difficult to assess. First, the stake that these investors had in Vedanta was allegedly small, and second, other financial institutions, such as Morgan Stanley or Credit Suisse, among other banks, willingly acted as bookrunners<sup>21</sup> in the issuance of Vedanta bonds *after* several instances of human rights violations had been exposed. This case illustrates the ambiguity with regard to measurable incentives set by the financial industry.

Summarizing the above explanations, I argue that although technically measurable, transaction cost increases in transacting with governmental agencies and financial institutions may not materialize, because these stakeholders are unlikely to react to the violations of ethical standards of *other* stakeholders, such as NGOs or communities.

When stakeholder reactions are uncertain, the benefits of self-regulation become harder to determine, thus making problems of measurement more relevant. Generally, I thus conclude that the monetary (or quantifiable) benefits of self-regulation in the mining industry are rather difficult to assess.

#### *Interdependence*

In order to identify the degree of interdependence between firms in their ability to self-regulate, it is necessary to differentiate between private and collective benefits of self-regulation.

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<sup>19</sup> For example, the industry-research company Datamonitor (2011) writes in its report on the European Mining Industry that contravention of EU regulations can lead to stringent financial penalties being imposed, which has been seen in “recent years with the introduction of legislation relating to the disposal of extractive waste, such as EU directive 2006/21/EC. The punitive costs for violations of environmental regulations increase and threaten margins. In fact, they now include criminal penalties in some jurisdictions. In EU countries, any company involved in operations which will result in the accumulation of extractive waste must deposit a financial guarantee with the relevant authority.”

<sup>20</sup> See Regjeringen.no (2007) and PGGM.nl (2010)

<sup>21</sup> See [Economietimes.com](http://Economietimes.com) (2010) and [Bloomberg.com](http://Bloomberg.com) (2010)

For that matter, I look at the previous transactions and ask whether the costs incurred here *must* be managed on a collective level.

As stated, a major competitive factor for mining companies is their ability to negotiate with host governments the access to mining sites and exploration sites. Bomsel et al (1996, p84) also state that “mining companies competitiveness is driven by the average production costs related to the quality of their site portfolio, because mining firms mainly compete on cost, and production costs are driven by the ecological characteristics of the site. As operation licenses are granted to firms by governments, the individual firm has an incentive to comply with the governments demands in order get access to sites where extraction is less costly.” For the case of environmental performance, the argument is that firms are in a competition based on environmental performance, because the gains from adhering to environmental standards are private. The logic is here that firms compete with each other for lucrative sites, which are given to the one with the best environmental performance. It is hence largely matter of individual commitment (and private transaction costs) to adopt certain standards in the operation. In that case, there is little incentive to cooperate for self-regulation, quite the opposite in fact. De facto, the need for self-regulation would fade because each firm is inclined to top its peers with regard to ecologically desired behavior.

However, this conclusion rests on the assumption that governments were truly granting access rights solely based on the environmental performance of a company. This assumption seems unrealistic to apply on a global scale, given that in many developing countries – where a substantial portion of violations of ethical norms prevails – governmental and regional agencies often do not demand particular environmental standards.

Moreover, governmental legislation usually affects the entirety of mining sites in a country and the entirety of companies that operate them.<sup>22</sup> Avoiding additional legislation in order to mitigate transaction costs is hence a collective good, which a single company – unless being a monopolist – can not supply alone. In that sense, there is hence interdependence between firms in transactions with the stakeholder “government”. This interdependence, however, can have negative or positive effects on establishing a common set of rules that institutionalize the desired behavior.

In the mining industry, there are in particular the different incentives of small mining operators, and the incentives of the big corporations that operate globally. While the latter are globally visible brands and under scrutiny from NGOs and media, the former often operate within a limited region, have no brand name, and sometimes even mine illegally.

Hilson (2000, p707) for example argues that in developing countries, it is not the multinationals that cause the big problems, as they operate at the same environmental level across the world, but the small local operations. Where government puts little pressure on the industry to improve environmental performance, these small firms have little incentive to adapt their behaviour. As each firm is individually a small polluter, the combined effect of these small operations is disproportionate compared to the rest of the industry. This represents a typical large number collective action problem as described by Olson (1965), because the individual contribution of a small firm is negligible it has an incentive to withhold

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<sup>22</sup> I simplify here in that I do not differentiate between the types of resources extracted. For example, regulations for bauxite mines may be different than for coal, zinc, or copper. For the purpose of the illustration, this simplification, however, does not subtract from the explanatory power of the approach.



its contribution while letting peers carry the cost of securing the collective good (in this case reduced governmental intervention).

A similar situation applies in the second type of transaction I identified – that between a mining firm and financial institutions as suppliers of capital. Here, benefits can be private: The already hard to measure effects of ethics violations and the reaction of financial institutions often only relate to a single firm. Hence, the incentive to commit oneself to ethical standards is private (again, in that case the problem vanishes, because individual commitment is sufficient to institutionalize a desired behavior).

Of course, overall industry performance plays a role in investment decisions, and hence reputational spill-over effects may occur which can only be managed on a collective level. However, given the identified problem of measurement with regard to banks, it is questionable whether this degree of interdependence would be conducive to establishing self-regulation rules.

In summary, this draws a rather gloomy picture for collective ethical standards in the overall industry, aside from those cases where there are private benefits from ethical behavior, in which self-regulation becomes obsolete anyhow. When these do not exist, however, the prevailing low degree of interdependence adds little incentive to engage in collective rule setting.

### *Costs of Supply*

Transforming mining operations as to make them more environmentally and socially acceptable incurs costs in various areas.

Environmental costs primarily relate to the production process: Examples are given in end of life metal disposal costs (Bomsel et al. 1996, p80) or the treatment of mine waste water used in quarrying minerals for chemicals, sediment, metals and pH before it is discharged into the environment (Hilson 2000, p701). Furthermore, improved environmental auditing in the firm, implementation of forefront environmental policies, and redesigning of plants to better accommodate wastes incurs transformation costs (Hilson 2000, p701), as does life cycle assessment and life cycle cost calculation, that is, the costs of design, production, operation, development, maintenance, support, and final disposal of a major system (such as a mine) over its life span (Kulczycka, Góralczyk, and Włodarczyk 2003, p14). The integration of socially sustainable practices can also be costly and time-consuming, (compare Epps 1997): In particular, costs are incurred in activities such as determining the effects of mining on the community, determining the likely participation of local people in the mine project, assessing whether parts of the population would have to be relocated and then actually relocating them, determining whether or not there is potential for conflicts among members of the community and then mitigating it, and not the least the economic costs of assuring the community's cultural inheritance is prevailed.

The degree to which these additional costs affect a firm's profitability can be substantial. This is illustrated by Humphreys (2001), who elaborates on the relative weight of environmentally and socially acceptable practices:

“Many such expenditures are a straightforward internalisation of that were previously external costs; which it to say, costs picked up by society at large in the form of the degradation of air or water, or the despoliation of landscapes. The reinforcement of a tailings dam or the



sterilisation of part of an ore body for environmental reasons may allow a miner to continue in business but they generate no rates of return. The same applies to the reclamation and rehabilitation of worked-out mine sites. Community programmes are real costs, without necessarily any immediate offsetting efficiencies. So also are the permitting costs which miners must incur before they have cash-flow, always assuming, that is, the permitting process enables them to get one.”

Although this development must be seen against substantial productivity growth in the mining industry, which has enabled it to “offset rising costs associated with the adoption of higher social and environmental standards” (Humphreys 2001), the impact of these costs is still substantial, as the mining industry is historically confronted with low profitability.

The relative impact of additional costs related to changes in the operation in order to make them more environmentally and socially acceptable increases further when taking into account the structure of competition in the industry.

Due to the enormous amounts of capital required to enter the mining business, exit costs are high. As many of the major tangible assets are highly specific to the mining industry, and thus hard to divest, most firms are strongly motivated to remain in the industry even when conditions are difficult. In addition, the commodity nature of products forbids substantial product differentiation in this industry and firms seldom differentiate their business beyond metals and mining. Complemented by the cyclical nature of the industry and the consequent volatility in prices and industry margins, these factors make for strong competitive rivalry in the mining industry (Datamonitor 2011). In particular small and medium sized companies, which cannot realize scale economies to the degree of large corporations, face enormous economic and technologic challenges in transforming operations towards more “sustainable” practices, which eventually make them turn to more environmental degrading means of production (compare Hilson 2000, p704).

Summarizing these arguments, the costs of transformation can be significant. This circumstance tends to create incentives to withhold one’s contribution to rules that effectively enforce internalization by the firms.

Transaction costs denote the value of those resources necessary to coordinate, monitor, and sanction the self-regulation regime members’ actions. Given the complexity of the industry and global mining operations, the design of mechanisms that assure the required level of coordination, monitoring, and incentive setting becomes very difficult. Coordinating on an effective set of rules becomes costly, because of the high variability in interests and incentives in the industry. For example, the costs of waste disposal can vary significantly, because heterogeneity between sites and countries regarding waste management costs is high (Kulczycka, Góralczyk, and Włodarczyk 2003). What should be the standard in such a case? The more specified the rules become, as for example many exceptions to a rule are formulated, the more complex and costly the design to monitor the adherence to rules.

What is more, there exist almost no levers with which incentive setting is possible. As there are no economic relations between mining companies – which would allow including standards in contracts – exclusion from the initiative is the only relevant alternative sanction for violations of standards. The incentive set by this measure, however, is limited, given the problems of measurement and interdependence. Losing membership in a regime whose (unclear) benefits can also be secured privately hardly represents a sufficient means for

deterrence. Hence, the incentive to contribute to mechanisms that are (1) costly (coordination and monitoring), and (2) of dubious effectiveness (sanctioning) is small.

In summary, the institutional approach to analyzing the mining industry illustrates the complexity and according incentives that influence successful design and supply of an effective self-regulation regime. One should suspect that the desired institutionalization of standards through self-regulation will largely fail because of the mining industry's structure.

Nonetheless, there exist a couple of initiatives and organizations in the mining industry whose purpose it is to exert self-regulatory measures on companies in that industry. Prominent examples are the Initiative for Responsible Mining Assurance (IRMA), the Global Reporting Initiative (GRI) Mining Sector Supplement, or the International Council on Mining and Metals (ICMM).<sup>23</sup> Although they differ with regard to their character, goal, organizational and member structure, regional scope, and the involvement of third parties, they all represent an attempt at ensuring higher social and environmental standards across the mining industry and consequently face the same structural problems. Given the previous illustration, one would expect that these initiatives have difficulties in supplying rules for institutionalization.

Contemporary research provides evidence that this is indeed the case. For example, arbitrariness in choosing to follow codes in the mining industry has been shown by Schiavi & Solomon (2007) and their discussion of the Minerals Council of Australia (MCA). Executives of Australian mining industry were interviewed with regard to the implementation of collective codes of conduct. They stated that they first look at the proposals of a code of conduct and then decide which content best fits their operation and which standards they actually wish to follow. This shows how problematic it is for the MCA to institutionalize a prescribed behavior.<sup>24</sup>

Similarly, the ICMM has been criticised by some authors (Seth & Emelianova 2006; Sethi 2005) for lack of specificity in the values and standards described in its framework, accusations against ICMM-members for human rights abuses while the ICMM being silent on this issue, and the lack of reporting on the level of compliance of member firms with the communicated ethical values. Sethi (2005) argues that it should not be expected that the ICMM will make measureable progress in reducing the externalities that are created by mining companies. In particular, he criticizes the disclosure policy of the ICMM and argues that the publicized information is at the discretion of the individual company, which may or may not choose to publicize certain information, and that hence, the credibility of the information is not given. A further argument is that formulations are not specific enough, for example, no minimum standards are defined, and no quantitative indicators for waste disposal or toxic waste treatment exist. He also laments the absence of monitoring and enforcement mechanisms. Generally, these authors argue that the ICMM's commitment is not credible because mechanisms of monitoring and sanctioning are absent.<sup>25</sup>

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<sup>23</sup> I exclude the Extractive Industries Transparency Initiative (EITI), because it is not a self-regulation arrangement in the traditional sense, given that significant government participation is required (See Haufler 2010). Members in the other initiatives are primarily international players like Rio Tinto, BHP Billiton, and Xstrata along with some national and regional mining associations. Participation of smaller corporations is very limited.

<sup>24</sup> Schiavi and Solomon (2007) show that those companies who needed to adopt the codes the most – small and medium sized ones – were in fact the ones abstaining from adoption.

<sup>25</sup> Note, however, that the ICMM states that it is trying to continuously improve processes in order to achieve a better performance and address relevant shortcomings (ICMM 2010).

Referring to a general problem in the mining industry, Jenkins (2004) also mentions lack of specificity with regard to relevant stakeholders as a shortcoming: He argues that in mining companies' sustainability reports, phrases such as communities are often used, however, it is not defined what community means and which stakeholders the companies perceive as relevant. Another example is Fonseca (2010), who highlights the problems with disclosure and assurance practices of mining companies. A lack of consistent approaches to reporting and getting third party auditing provides evidence that monitoring processes are not institutionalized in the industry yet. In a similar manner, problems with a lack of quantity and divergence between quantity and quality in mining reports are discussed by Guenther, Hoppe, and Poser (2007).

## **Conclusion**

Although this anecdotal evidence hints at the validity of the assumption that the mining industry structure indeed hampers the supply of effective self-regulation, it goes without saying that a solid confirmation of this idea would require detailed institutional analysis of each of the relevant initiatives. However, empirical analysis of the mining industry is not the aim of this paper.

Rather, the intention is to provide an illustration for the critical reflection of the concept of effective collective commitment, and how difficult it is to achieve it on purely (monetary) measurable accounts. Thus I argue that with the institutional and transactional approach proposed here, it becomes possible to devise some general insights on the functionality of industry self-regulation.

In doing so, this paper wishes to contribute to an understanding about the limits of self-regulation by pointing out the requirements that influence its feasibility in a particular case and the factors that must be kept in mind when self-regulation is discussed as a means for making the world 'more ethical'.

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