

Are Firms in the U.S. More Responsible Than Firms in Europe: Consumer Boycotts and Firms' Ethics*

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Abstract

Consumers care both about the products they buy and about the images of the firms producing the goods they buy. To affect a firm's ethical behavior, consumers may refuse to buy from some firm, and may pressure other consumers to boycott that firm. Moreover, workers who care about their status, may influence the firms' behavior when faced with ethical choices.

Key words: consumer boycott, image, status

JEL classification:

1 Introduction

A firm deviating from an accepted social norm like environmental protection, sound personnel policy, or non-use of child labor may risk punishment by consumers. Examples of such punishments are many. Shell Oil suffered damage to its image from the military action of the Nigerian government against domestic protests aimed at protecting the delta of its river. Nestle suffered from lost reputation after selling inappropriate milk to pregnant mothers in developing countries. The accounting firm Arthur Andersen never recovered from its involvement with Enron. When Turku Mustard was bought by a Swedish firm which moved production to Sweden, Finnish consumers boycotted their favorite

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mustard, causing its share price to fall by about ten percent. In 2005, an Estonian ship, owned by Tallink, was caught releasing waste into the Baltic sea. After passengers started to organize a boycott against the firm, it only took two days for the firm to announce a change in its policy, pledging to safely release waste into containers in Helsinki. The plan of the firm producing the British condiment HP sauce to move production to the Netherlands caused a consumer boycott.

In a consumer boycott it is typical that a consumer who joins the boycott is willing to pay a higher price than available for a product of a deviating firm which is subject of a boycott. Moreover, those organizing the boycott often want to see that other consumers join. A special feature of a boycott is thus that it is group phenomenon; that is, a boycott has features of a network good, where the (utility) gain to a consumer of joining a boycott increases with the number of other boycotters.¹ The development of the internet and of other modern means of communication provides consumers with new instruments to influence the ethical behavior of other producers. The consumers' concerns induce firms to devote attention to their image among consumers. Indeed, the internet home pages of many firms describe today their work in helping development projects and controlling environmental damage. In other words, firms undertake costly investments outside the scope of their business area to build up reputation among consumers.

Our paper asks how consumers decide on whether to join the boycott or not. We also address the question how firms behave under the threat of a boycott. We consider what types of market equilibria are available. In particular, we ask whether a boycott can effectively direct corporate ethics towards accepted social norms and how competition interacts the firms' behavior. The existing literature is meager. A few papers study corporate ethics, but none concerns consumers' actions. We introduce a model, where competing firms produce identical products but can choose their corporate ethics differentiating their image among consumers. Consumers observe the behavior of firms and take ethical positions organizing a boycott against the deviating firm. The efficiency of a boycott is determined by the moral reaction of consumers and the cost they impose on those consumers who do not join the boycott. Joining the boycott signals the type of a person in his reference network. Consumer opportunism and the option of free riding reduce the success of a boycott. A firm can respond to a boycott by playing tough or weak depending on to what extent their image is important for them.²

¹Arla is an interesting special case in that its boycott in the Islamic world led to a counter boycott among the western consumers regarding the initial boycott unfair.

²Its reaction results in a particular reputation and may influence the success or failure of a future boycott. We do not take up this extension in the current paper.

2 Assumptions

2.1 Consumers and equilibrium

We model a duopoly market where two firms compete for customers. The products (or services) are identical. The mass of consumers is scaled to 1. Each consumer buys at most one unit of the good. Consumers are indexed in decreasing order by $x \in [0, 1]$ with respect to their basic willingness to pay for the product. Consumer $x = 0$ has the highest basic willingness to pay for the product, say β ; consumer $x = 1$ has zero willingness to pay for it. The willingness to pay by the remaining consumers is uniformly distributed on $(0, \beta)$. The net utility of consumer k is then given by an indirect utility

$$u_k = \beta(1 - x_k) - p,$$

where p is the market price. In the initial equilibrium, both firms produce thus the same output.

2.2 Boycotting the deviant

Suppose now that one of the firms decides to save in the production cost by starting to pollute and thereby acquiring a cost advantage, $c > 0$. The media whose social contribution is in searching for scandals catches the firm which deviates from the norm with probability $\eta > 0$. Consumers get both informed and angry. Their willingness to pay for (the net utility of) the product is unchanged. They do not want to buy the product of the polluting firm in the first place. There will be a demand switch from the product of the polluting firm to the product of the non-polluting firm. But how big? Can the polluting firm survive? To address these questions, we introduce the rest of the model.

2.3 From homo oeconomicus to homo moralis

Ethical preferences To introduce the moral aspirations, we assume that there is a utility loss for those buying from the polluting firm. Thus, we expect that the market is segmented into two groups of consumers. Denoting the prices of the firm with a high ethical code and with a low ethical code by p_H, p_L , we write the net utilities of consumers in those groups as

$$u_i = \beta(1 - x_i) - p_H, \quad v_j = \widehat{\beta}(1 - x_j) - p_L.$$

where the utility loss of the consumer buying from the deviating firm is given by $(\beta - \widehat{\beta})(1 - x)$. This utility loss then serves as a measure of how strongly people can switch from homo oeconomicus to homo moralis. We assume that relative decline in valuation is equal across consumers.³ The paper leaves it open

³Where the ethical preference comes from is beyond the scope of the current paper. A natural proposal is that the preferences are created by evolutionary mechanisms within human beings as part of a social contract, cf. Binmore (1998). It is appropriate to think that the ability to commit to a social norm with an option to participate in a boycott develops like meme in the sense of Dawkins (1976).

whether one should trust markets in formation of values and whether a boycott is an efficient instrument. However, if the starting point is individualistic, one should take seriously the moral concerns expressed by individuals.

A boycott, however, may take place in various types. In the case of above, the boycott is a mild one. In other cases, the boycotters may impose pressure on those who do not join the boycott and buy from the deviating firm. A boycott tends to be a group phenomenon in two ways. It gives utility to the organizers and it provides a disciplinary mechanism in imposing social norms.⁴ Pollution itself represents an externality. The group pressure represents another externality. It reduces the well-being of those who are free-riders in imposing social norms. Consumers tend, however, also to be opportunistic in the sense that they would like to induce others to join without committing themselves. The reason is that a successful boycott leads to a lower price as demand is reduced. We work out the case where all people who do not buy from the polluting firm express their pressure.

The reason for that the social pressure can work is that people are keen to maintain their reputations and avoid a signal which makes them unpopular in their reference group. We introduce the network effect through a linear function $rx_m, r > 0$ and the pressure through a function $w(x_m), w'(x_m) > 0$ where x_m will below denote the number of consumers buying from the non-polluting firm. We will consider below two cases, a linear one and a non-linear one. In the non-linear case, the group pressure is small for a small number of customers of the non-polluting firm and thus a large number of customers of the polluting firm. However, it intensifies radically when the number of customers of the non-polluting firm increases and the number of customers of the polluting firm simultaneously decreases. This results in the possibility of multiple equilibria.

A boycott is not, however, a free lunch for the boycotters. As more join, they incur a cost in terms of a higher price of the non-polluting firm, which opportunistically reoptimises its output. On the other hand, as a boycott is a group phenomenon, their utility is increasing in the number of boycotters which increases the probability of a successful boycott. They face a trade-off between moral satisfaction and a sacrifice in terms of a higher price.

The deviating firm rationally anticipates the reaction of the customers. It also faces a trade-off. By polluting, it can reduce its costs but is also loses its image and some customers. The cost saving is a decisive determinant of its choice. If it anticipates that it will be caught with probability $\eta > 0$,⁵ and denoting the profits of the firm with high and low ethical code, respectively, by

⁴People may differ as to the cost of organizing a boycott. In today's world with internet, the cost presumably is lower than earlier. We abstract from the cost of the initiative.

⁵The current model assumes that consumers are able to identify the firms which abstain from having sound ethical code of conduct. In today's world, this may be difficult as products are highly complicated and their production is based on a number of sub-processes in various countries. Diamond (2005) has, for example, pointed out that it is hard for consumers to know the mine from which copper in the product comes from while the oil producers can be identified. This makes oil companies behave more ethically than the mine companies.

π^H and π^L , the deviant is maximizing

$$(1 - \eta) \pi^{DH} + \eta \pi^L.$$

Profit π^{DH} should be understood to be the profit under a symmetric duopoly where the deviant is not captured but where the deviant has a lower production cost. In the current paper, we work out the case where $\eta = 1$.

Those consumers who do not join the boycott understand that they will benefit from the lower price of the deviant firm. These consumers thus face a trade-off between lower moral satisfaction and lower price and subjecting themselves to social pressure.

The outcome of this complicated process is an industry equilibrium where the market shares of the two producers are revised and where consumers are divided between boycotters and non-boycotters. We do not model the *process* leading to the industry equilibrium. We introduce a model which states what the equilibrium *in the end* will look like.

With a social satisfaction and the pressure effect, the utility of consumers (i, j) who buys from firms H and L is then

$$u_i = \beta(1 - x_i) + rx_m - p_H, \quad v_j = \widehat{\beta}(1 - x_j) - w(x_m) - p_L.$$

Here p_L is the price charged by the boycotted firm; we emphasize that the prices are yet to be determined, jointly with the number of buyers.

3 Monopoly case

It is useful to consider first a monopoly subject to a boycott. As it has no competitors, a monopoly may be less sensitive to a boycott than are firms facing competition.

We solve first for the monopoly case who does not pollute. Not polluting requires a capital investment, with an annual cost of c . Some consumer is the marginal one, say x_M , enjoying zero net utility $\beta(1 - x_M) - p_M = 0$. The monopoly profit is

$$\pi_M = p_M x_M = [\beta(1 - x_M)] x_M - c.$$

Maximizing with respect to output, one obtains

$$x_M = \frac{1}{2}, \quad p_M = \frac{\beta}{2}, \quad \pi_M = \frac{\beta}{4} - c.$$

Suppose now that the monopoly firm is caught from cost-saving pollution. It will lose some customers to say $x'_M < x_M$ as the willingness to pay by consumers is lowered. Only those with high willingness to pay buy the monopoly product. Suppose that in the monopoly case, all those people who do not buy from the

monopolist, express the pressure, making the penalty function $w(1 - x'_M)$. The monopolist is now able to charge a lower price

$$p'_M = \widehat{\beta}(1 - x'_M) - w(1 - x'_M).$$

The monopoly profit will be

$$\pi'_M = p'_M x'_M - c = \left[(\widehat{\beta} - w)(1 - x'_M) \right] x'_M.$$

The profit-maximizing output continues to be $x'_M = \frac{1}{2}$ while the price is reduced to

$$p'_M = \frac{\widehat{\beta} - w}{2}.$$

However, the profit is not necessarily reduced as it is

$$\pi'_M = \frac{\widehat{\beta} - w}{4}.$$

The boycott is ineffective as a disciplinary mechanism if the cost saving is sufficient relative to the loss of customers, i.e. if

$$c > \frac{1}{4} \left(w + (\beta - \widehat{\beta}) \right).$$

Consumers' ethical code of conduct can, however, impose discipline on the monopolist as can the pressure which consumers exercise on those buying from the polluting monopolist.⁶

4 Consumer Power When Firms Compete: Duopoly

We turn next to duopoly. We let the firms produce identical products. We also allow them to adopt different ethical codes of conduct, so that the images of the firms are different. The firm's choice is whether to pollute or not. In our model, firm H does not pollute while firm L does. Some activist consumers, x_m , want to buy only from H . They also want to impose the same principle on others. Those, who join the boycott, obtain a utility from that action while those who buy from L subject themselves to a penalty $w(x_m)$.

Utility from buying from firms H and L are then

$$u_i = \beta(1 - x_i) + rx_m - p_H; \quad v_j = \widehat{\beta}(1 - x_j) - w(x_m) - p_L.$$

The firms' profits are

$$\pi^H = p_H x_H - c; \quad \pi^L = p_L x_L.$$

⁶No formal welfare analysis is carried out at this point. A planner would, however, take into account the cost of pollution on consumers' welfare and the effects on boycotters' welfare of the action of organizing a boycott while not neglecting the externality on those who do not join.

The number of activist consumers is x_m . Thus, it is consumer m who is indifferent between buying from the non-polluting and polluting firm. Consumer n is indifferent between buying from the polluting firm and buying from none. In equilibrium. For these marginal consumers it holds

$$\beta(1-x_m)+rx_m-p_H = \widehat{\beta}(1-x_m)-w(x_m)-p_L; \quad \widehat{\beta}(1-(x_m+x_n))-w(x_m)-p_L = 0.$$

Thus, market prices are

$$\begin{aligned} p_L &= \widehat{\beta}(1-(x_m+x_n))-w(x_m); \\ p_H &= \beta(1-x_m)+rx_m-\widehat{\beta}x_n \end{aligned}$$

Firm H benefits from consumers boycotting firm L . With more people buying its good, it can raise the price, whereas firm L must lower its price. The lower price attracts consumers who face a trade-off between buying the cheaper product but being subject of punishment.

Profits are

$$\begin{aligned} \pi^H &= [\beta(1-x_m)+rx_m-\widehat{\beta}x_n]x_m - c \\ \pi^L &= [\widehat{\beta}(1-(x_m+x_n))-w(x_m)]x_n. \end{aligned}$$

We derive now the Cournot reaction functions,

$$\begin{aligned} x_m &= \frac{\beta - \widehat{\beta}x_n}{2(\beta - r)} \\ x_n &= \frac{\widehat{\beta} - \widehat{\beta}x_m - w(x_m)}{2\widehat{\beta}} \end{aligned}$$

The reaction function of the non-polluting firm is linear while that of the polluting firm is (potentially) non-linear depending on the nature of the boycott.

4.1 Linear penalty

With a linear penalty function, $w(x_m) = wx_m$. The Cournot-Nash market shares are given by

$$\begin{aligned} x_m &= \frac{2\beta - \widehat{\beta}}{4(\beta - r) - (\widehat{\beta} + w)} \\ x_n &= \frac{\beta - 2r - \beta w/\widehat{\beta}}{4(\beta - r) - (\widehat{\beta} + w)}. \end{aligned}$$

We notice first that with ethical preferences, i.e. $\beta > \widehat{\beta}$, the market share of the firm with an ethical code of conduct is always greater than in the absence of those preferences. The cost inflicted upon the non-boycotters, w , raises the market share of the non-polluter, firm H . Moreover:

Proposition 1 *A sufficient condition for the boycott to drive the polluting firm out of the market ($x_n = 0$) is that a non-boycotting consumer expects that violating the boycott will inflict a personal cost of*

$$w = \frac{\beta - 2r}{\beta/\hat{\beta}}.$$

We notice that a high network effect among boycotters makes the required penalty effect small. Low moral reaction (high $\hat{\beta}$) has the opposite effect: it raises the required penalty.⁷

4.2 Increasing penalty effect: unstable multiple equilibrium

Suppose now that with a small number of boycotters, the social penalty is small but that it is strongly increasing with the number of boycotters. Assume then that

$$w(x_m) = wx_m^2.$$

With reaction functions

$$\begin{aligned} x_m &= \frac{\beta - \hat{\beta}x_n}{2(\beta - r)} \\ x_n &= \frac{\hat{\beta} - \hat{\beta}x_m - wx_m^2}{2\hat{\beta}}. \end{aligned}$$

With an increasingly strengthening social penalty, the reaction function of the L - firm is declining but concave. Concavity suggests that there are two equilibria, one with an unsuccessful boycott and one with a successful boycott as the reaction functions now intersect at two points. Those equilibria are the fixed points of the indifference condition of the marginal boycotter

$$\beta(1 - x_m) + rx_m - p_H = \hat{\beta}(1 - x_m) - wx_m^2 - p_L,$$

where - one should remember - the prices are endogenous.

Stability analysis, however, suggests that both the equilibria, call them E_1, E_2 are unstable. Suppose that the actual number of boycotters was less than expected by the non-boycotters, $x_m < x_m^e$. This creates an incentive for the marginal boycotter not to join, x_m becomes smaller regardless of the equilibrium. Similarly, if the actual number of boycotters appeared to be greater than expected by the non-boycotters, $x_m > x_m^e$, the marginal non-boycotter has an incentive to join, x_m is increasing. Again, both equilibria are unstable. We suggest

⁷In this section, we assumed that the firms had ex ante committed to be of type H or L . This choice can be endogenized. In equilibrium and depending on the cost c , both firms may be of type H or L , or they may be indifferent. A necessary condition for the existence of a mixed equilibrium is that they have access to different non-pollution technologies, thus facing a different non-pollution cost c . Kanninen and Pitarila (2006) suggest that adoption of the code of ethical conduct across firms may result from prisoners' dilemma.

Proposition 2 *With an increasingly strengthening social penalty, there cannot be a mixed equilibrium with to firms having different ethical codes of conduct.*

5 Boycott and the risk of bankruptcy

The model above assumed that the product is delivered at the time of payment. We now briefly consider the case where the delivery is made after payment, generating a risk that a firm may exit the industry with assets less than liabilities, so generating losses to consumers who paid that firm. Accordingly, assume now that both firms face a fixed production cost in each period. If the boycott is highly effective, the customers of firm L may not obtain the product or service. Consumers' expectations now become even more crucial than they were above.

Even if buyers from firm L bear no cost other than the price, they may stop buying from firm L if they expect fewer consumers to buy from it. This reduced demand can make firm L 's profit negative and force it to exit the industry. Re-write the profit functions as

$$\pi^H = p_H x_H - c - F; \pi^L = p_L x_L - F.$$

The zero-profit condition $\pi^L = p_L x_L - F$ implies a lower limit for the number of customers of firm L that allows it to stay in the industry. If the expected number of consumers is lower, no consumer buys from firm L .

Proposition 3 *Boycotts are more effective when consumers expect that the firm can go bankrupt.*

6 Does Intensified Competition Make Boycotts Effective?

When consumers do not judge the ethics of firms—and it is an empirical question whether they do—each firm can capture the whole market by undercutting the rival's price. As is well-known, a strong background assumption in the standard model of Bertrand price competition is that a firm can serve the full market, or that it has large capacity. Suppose, that a firm's capacity is unconstrained. Then, with undifferentiated products, the only equilibrium has a price equal to marginal cost.

Once consumers value corporate ethics, the game differs. If a firm can behave ethically with no cost disadvantage, the ethical code spreads like an aggressive meme and all firms are ethical.⁸ What may prevent the appearance of an ethical code as such a meme is the cost disadvantage. The ethical firm must be able to charge a price exceeding the marginal cost under unethical behavior to cover the implied cost, while the unethical firm tries to undercut the price. Now,

⁸The idea of a social gene, "meme" in contrast to the biological gene, was introduced by Dawkins (1976).

consumers' moral values can make them pay attention to differences in the firms' images. A mixed equilibrium is possible.

The indifference condition (with $r = 0$ as a simplification) for the marginal consumer, x_m , requires that

$$p_H - p_L = (\beta - \widehat{\beta})(1 - x_m) + wx_m.$$

The last consumer, x_n , buys at the price

$$p_L = \widehat{\beta}(1 - (x_m + x_n)) - 2w.$$

Thus, the demand functions are

$$x_m = 1 - \frac{(p_H - p_L) - 2w}{\beta - \widehat{\beta}}, x_n = \left(\frac{\beta}{\widehat{\beta}}\right) \frac{(p_H - p_L) - 2w}{\beta - \widehat{\beta}} - \frac{p_H + w}{\widehat{\beta}}.$$

The profits are

$$\pi^H = p_H \left(1 - \frac{(p_H - p_L) - 2w}{\beta - \widehat{\beta}}\right) - c; \pi^L = p_L \left[\left(\frac{\beta}{\widehat{\beta}}\right) \frac{(p_H - p_L) - 2w}{\beta - \widehat{\beta}} - \frac{p_H + w}{\widehat{\beta}}\right].$$

This section is preliminary but suggests that

Proposition 4 *A boycott is more efficient under Bertrand than under Cournot competition.*

To prove, solve for $\pi^B = 0$ in both scenarios to find out that under Bertrand competition, the B - firm more easily hits this constraint.

7 How Should the Boycotted Firm Respond?

The firm subject to a boycott may play soft or tough. Playing soft means that it behaves ethically, paying the extra cost, c (cf. the Tallink case above). Playing tough means that it continues to behave unethically. Tough play has two effects. First, the current cost c can be avoided. Second, the threat of a future boycott is reduced as consumers expect that fewer people join the boycott. The reputation building helps. The optimal strategy choice depends on two factors. First, it depends on whether the cost to be avoided is a one-time sunk cost or whether it is a continuous (fixed or variable) cost. Second, the strategy depends on the expectations of the firm on the effectiveness (extent) of boycott, that is, on how many consumers might join. For example, after the magazine Seven Days published the picture of the singer of the Lordi Band, it faced a substantial boycott in May 2006.⁹ The magazine had to apologize publicly - though at no cost!¹⁰

⁹Band Lordi, the winner of the European song contest and using masks to cover the faces of the band members had asked that their faces be hidden.

¹⁰In the current stage of the project, we do not model explicitly. We suggest that one can calculate the profit under the two strategies and an expectation of how strongly consumers punish each other and arrive at the optimal strategy. We obviously have multiple equilibria, depending on the firm's expectations about w , the cost of not joining the boycott. Four types of equilibria may arise, depending on consumers' expectations: (HH , HL , LH , LL).

8 Can the Competitor Help the Boycotters?

Each firm has an incentive to drive the other firm out of the market. Firm H can encourage such exit by lowering its initial price sufficiently to attract customers from L , which is already suffering from customer loss. This effect may be particularly relevant if re-entry costs are high and exceed the cost of exit.

9 Status Among Workers: Snowball Effect

Workers tend to prefer to work in the firm with high quality. First, working in a firm with a good reputation increases the worker's social standing. Second, a worker may want to change the behavior of an unethical firm. The worker can contribute to the latter outcome in two ways. First, he can choose to work at a lower wage at the firm he prefers. Second, he can switch to another firm.

In terms of a game in extended form, we suggest a two-stage game. In the first stage, the firm which has been seen to pollute chooses whether to stop polluting, or whether to change its behavior, i.e. to adopt an ethical code of conduct. In the second stage, the workers can choose whether to work at a lower wage or to switch to another employer. The cost of moving to another firm may be country specific. In Europe, it is typically thought to be high. In the United States, it is low. We suggest that the threat of losing high-quality workers disciplines firms in the United States, but less so in Europe with lower mobility (higher mobility costs). This comparison is a rather dramatic implication of our analysis,

Proposition 5 *High labor mobility can encourage firms to behave ethically.*

To prove this, suppose workers are identical in their productivity, and that the labor market is competitive. Suppose, however, that a worker's utility increases both on his wage and on the image/status/reputation of the firm at which he works:

$$U = w + s.$$

Now, the wage the firm pays can be adjusted to its image. The ethical firm can pay a lower wage than the nonethical firm. Call the wage differential s . Suppose that to produce its output, each firm employs just one worker. Then, the firms' profits are

$$\pi^H = p_H x_H - (w - s) - c; \pi^L = p_L x_L - w.$$

An ethical firm thus enjoys a second-round benefit, a snowball effect in terms of cost saving. Its relative profit increases for two reasons: consumer boycott of firm L and the cheaper labor arising from the status effect.

Lastly, our results may also show why a race to the bottom has not appeared in the European Union, despite large redistribution within some countries.

10 Final Remarks

The modern communication devices including the internet provide new instruments for consumers to influence the ethical behavior of producers. This increased influence has induced firms to devote substantial effort on their image among consumers. The internet home page of a firm often highlights the firm's contributions to economic development or to environmental quality. Consumer power has been increasing and it will continue to increase. Consequently, with increasing environmental issues like the greenhouse phenomenon, one can expect that we will see more boycotts in the future than we have seen so far.

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